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Israel M. Kirzner — Mises and His Understanding of the Capitalist System
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EDITOR'S NOTE

This special issue of the *Cato Journal* commemorates the 50th anniversary of Ludwig von Mises' classic *Human Action* (first published by Yale University Press in 1949) and the 100th anniversary of F. A. Hayek's birth (Hayek was born in Vienna in 1899 and died in 1992).

These two giants of market-liberal thought exposed the fallacies of central planning, pointed to the importance of private property rights and limited government in promoting a spontaneous market order, and explained the role of institutions in shaping incentives and behavior.

The papers by Vernon Smith, Israel Kirzner, Kenneth Elzinga, and George Selgin (along with the comments by Lawrence H. White, Gordon Tullock, Frank Machovec, and Richard Timberlake) were first presented at the Western Economic Association Meeting in San Diego, July 7, 1999, at a session on "Mises' *Human Action*: A Critical Appraisal after 50 Years." That session was organized by Don Boudreaux, president of the Foundation for Economic Education. I thank him and the authors for their cooperation in preparing the papers for publication.

Ronald Hamowy and Stephen Macedo prepared papers to mark the centenary of Hayek's birth. Those papers were presented at a special celebration at the Cato Institute on May 8, 1999, and revised for publication. Both authors are to be commended for their efforts.

In addition to the papers **On the Legacy of Mises and Hayek**, this journal contains several other articles dealing with important policy issues.

—J. A. Dorn

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Reflections on *Human Action* after 50 Years

Vernon L. Smith

The core of Ludwig von Mises' thought is the theory of human action, or praxeology, the general science he seeks to articulate. Within this general science is included—embedded in it—catallactics, or the science of exchange (Mises [1949] 1996: 1–3; hereafter M). Consequently, to Mises everything we seek to study in economics stems ultimately from individual choice, the key to which is subjectivist economics (stemming from the 1870s revolution by Menger, Jevons, and Walras). Thus, "Choosing determines all human decisions. In making his choice man chooses not only various material things and services. All human values are offered for option. All ends and all means . . . are ranged in a single row and subjected to a decision which picks out one thing and sets aside another" (M, p. 3). Moreover, "Human action is necessarily always rational" (M, p. 19). For Mises this is a truth, not a hypothesis to be tested that can be right or wrong. This is because praxeology is neutral with regard to any value judgments concerning its data—that is, the ultimate ends chosen in human action. Hence, there is no objective basis for asserting that anyone's choices can be irrational.

Externalities (whether costs or benefits) are not a problem in principle for Mises because he saw clearly, as did Coase, that these involve the delineation of property rights—the problem of no man's property, or public free access resources. The problem is one of holding individuals accountable though liability for those costs of human action that are borne by others. Mises sees the principle of liability as being widely accepted; any alleged deficiencies he attributes to loopholes "left in the system" (M, p. 658). Finally, in this thumbnail sketch there are the well-known strong views of Mises against intervention: "There are hardly any acts of government interference with the market

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process that, seen from the point of view of the citizens concerned, would not have to be qualified either as confiscations or as gifts. . . . There is no such thing as a just and fair method of exercising the tremendous power that interventionism puts in the hands of the legislature and the executive" (M, p. 734). We also see even the foreshadow of rent seeking and public choice when he summarizes his discussion of corruption, as inevitably "a regular effect of interventionism" (M, p. 736). So the theory of choice is much more than the "economic" side of human endeavor—it is central to all human action.

I first read Mises when I was a senior at CalTech, graduating in electrical engineering. It was one of several reasons why I subsequently shifted to economics. Reading Mises after 50 years, I am impressed with how stimulating, relevant, and crisp *Human Action* is for the state of economics at the end of the second millennium. It has endured well because many of its major themes—property rights, liability rules, the efficacy of markets, the futility of interventionism, the primacy of the individual—have become important elements in microeconomic theory and policy. Moreover, these themes have become important because of Mises, Hayek, and others on the fringe (e.g., Coase, Alchian, North, Buchanan, Tullock, Stigler, and Vickrey, to name a few) and not because of mainstream economic theory. There is plenty in Mises to update because of things we think we now know that we did not know 50 years ago. But Mises' basic message as to how economies function is as good today as it was then. What has changed with great leaps is the methodologies for studying the nature of human decisionmaking. In this brief encounter I am going to pick up several themes in Mises that I will use to illustrate this change. I will also complement that discussion with some commentary on Hayek, for this year is the 100th anniversary of his birth. So there is much to celebrate with the Austrians.

On Human Action and Laboratory Experiments

Mises' views on experimental methods reflect the methodological outlook that was universal in the profession 50 years ago—namely that economics is necessarily a nonexperimental science:

> There are . . . some naturalists and physicists who censure economics for not being a natural science and not applying the methods and procedures of the laboratory. . . . But the experience to which the natural sciences owe all their success is the experience of the experiment in which the individual elements of change can be observed in isolation . . . the experience with which the sciences of human action have to deal is always an experience of complex phenomena. No laboratory experiments can be performed with regard to human

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> action. We are never in a position to observe the change in one element only, all other conditions of the event remaining unchanged [M, pp. 7–8, 31].

My view is that the reason economics was believed to be a nonexperimental science was simply that almost no one tried or cared. Mises' view was universal then, and is still frequently encountered. Thus, Charles Holt, a distinguished and leading experimentalist, was warned by his advisor that experimental economics "was a dead end in the 60s and it would be a dead end in the 80s" (Kagel and Roth 1995: 428, n. 8). What is not clear is why what had been a dead end in the 1960s survived to be a new dead end in the 1980s. In the few remaining months of 1999, I look forward to it being another dead end in the 1990s. I am reminded of Paul Samuelson's quip that science advances funeral by funeral.

In fact, last year was the 50th anniversary (passed without recognition) of the first paper about market experiments in economics (Chamberlin 1948). What Chamberlin thought he showed was that competitive market theory does not work. (Although the experiments run in his classes were designed to set the stage for the need for his theory of monopolistic competition, his experiments did not show that markets fail to yield substantial gains from exchange). My critique and modifications of the Chamberlin experiment, including the introduction of monetary rewards, and a change in focus to the role of institutions ("market organization") are reported in Smith (1991: 1–55). Once the important role of institutions (the rules of a particular market) is recognized, there is nothing strange or unusual about Chamberlin's results. Experimental economics is strongly supportive of Mises' theory of market prices, but also for equilibrium theory under stationary and even dynamically shifting conditions. All equilibrium theory was seen by Mises as an "imaginary construction" (M, pp. 250–51). As indeed it was, as were many of Mises' important contributions. Such is the nature of theory, all of which was developed without an expectation that anyone would actually try to test it in the laboratory. What market experiments did for me was to bring to life this "imaginary construction." Before my very eyes people with private information, who therefore had no prevision of the ends they were achieving, maximized the gains from exchange and approximated equilibrium outcomes.

There have now been many hundreds, probably thousands, of experimental demonstrations of the power of markets—especially when organized under the "double auction" institution common in all financial and commodity markets—to yield efficient competitive outcomes, but also in posted offer and one-price sealed bid-offer clearing markets

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(see Kagel and Roth 1995, Davis and Holt 1993, Smith 1991). These results, which have been replicated by a host of investigators, are robust with respect to the subject pools used: undergraduates, graduates, high school students and teachers, businessmen and women; then in the mid-1980s we ran an experiment using administrative employees of the Department of Energy making it plain that regulators could just as naturally make a market.

What we learn from such experiments is that any group of people can walk into a room, be incentivized with a well-defined private economic environment, have the rules of the oral double auction explained to them for the first time, and they can make a market that usually converges to a competitive equilibrium, and is 100 percent efficient—they maximize the gains from exchange—within two or three repetitions of a trading period. Yet knowledge is dispersed, with no participant informed of market supply and demand, or even understanding what that means. This strikingly demonstrates what Adam Smith called "a certain propensity in human nature . . . to truck, barter, and exchange one thing for another" (Smith [1776] 1909: 19). Also, it demonstrates Mises' assertion that "Everybody acts on his own behalf; but everybody's actions aim at the satisfaction of other people's needs as well as at the satisfaction of his own. Everybody in acting serves his fellow citizens" (M, p. 257).

On Evolution and the Primitive Mind

Mises' understanding of evolution accords well with contemporary interpretations, such as that of evolutionary psychology (Tooby and Cosmides 1992).

> The human mind is not a tabula rasa on which the external events write their own history. It is equipped with a set of tools for grasping reality. Man acquired these tools, i.e. the logical structure of his mind, in the course of his evolution from an amoeba to his present state. But these tools are logically prior to any experience. . . . No facts provided by ethnology or history contradict the assertion that the logical structure of mind is uniform with all men of all races, ages and countries [M, pp. 35, 38].

This is essentially the current evolutionary psychology perspective on evolution, mind, and, specifically, natural language. The claim that we acquire mental tools prior to experience is particularly well illustrated in the study of how we acquire language: "When researchers focus on one grammatical rule (examples in English are the algorithms that add '-s' to a regular noun to form its plural; and to add '-ed' to form the past tense of a regular verb) and count how often a child obeys it and how often he or she flouts it, the results are astonishing:

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for any rule you choose, three-year-olds obey it most of the time" (Pinker 1994: 271). The interpretation is that the brain comes pre-equipped with circuitry ready to absorb the syntax of any language; initialization of the circuitry requires only exposure to talking others to set the switches. The exceptions (errors) of three-year-olds actually help to prove the principle: "two mans are at the door," or "he builded the house." Irregular verbs and nouns have to be memorized, and dubbed in by a mental process that first blocks the inflection algorithm, then dredges up the irregular case from memory. Many irregular cases are rarely used by adults, so it takes longer to develop the blocking/substitution process, and the three-year-old always substitutes the regular-case algorithm. This is how language modules in the brain naturally work. Adults do the same. How often do you hear the past tense of *strive* (*strove*) or *tread* (*trod*)? For many, so rarely that they regularize with *strived* or *treaded* (Pinker 1994: 273–76). In fact, *strove* and *trod* tend to sound pretentious to many ears, suggesting that the user knows something important that you do not. Note that the use of inflection algorithms is the brain's way of conserving scarce memory and access resources. You only need to store in memory the basic roots and stems, then invoke autonomic algorithms to leverage the basic words into a far larger vocabulary. Thus, "an average American high school graduate knows 45,000 words—three times as many as Shakespeare managed to use . . . in his collected plays and sonnets" (Pinker 1994: 150).

But some reject these interpretations of language, arguing that our language ability is not an adaptation but an exaptation—a device that evolved for other purposes but is seized or recycled for a new purpose (Gould and Vrba 1981). Such views, however, seem to me to be diversionary. Adaptation can be complex, and seizing a module that to a biologist "looks like" it has been developed for another purpose is just one of the many paths that evolutionary adaptation can take. It is a wise person indeed who can say what a particular biological mechanism originally evolved for. You do not have to believe that language developed because a protohuman spoke a word that increased the person's fitness, and that this word gene then flourished in the population. Mises does not pretend to know how evolution has created human mental capacity, but for him it is just as natural to think of the mind as an evolved phenomenon as it is to believe that the evolutionary process created arms and legs.

Gould and Lewontin (1979) have accused many evolutionary biologists of assigning too much credence to natural selection. Mises' intellectual descendants will find amusement in Pinker's (1994: 359) assessment of the influential paper by Gould and Lewontin: "One of their

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goals was to undermine theories of human behavior that they envision as having right-wing political implications." Harvard's Gould is of course a prominent example of the claim by some wag that the only Marxists left in the world are teaching in British and American universities. It seems that left-wingers who promote the perfectibility of humans through social (i.e., government) control fear the implications of ascribing too much influence to nature, while right-wingers (at least the subset who are strong on limited government) fear the statist implications of human malleability. This is the nature versus nurture debate, which is fraught with underground political biases. Mises comes down on the side of nature in arguing that the mind has tools that are not part of experience. But the mind has those tools because they were adaptive, because they flourished in environments that did not block their expression. Thus an important contemporary view is that of the coevolution of nature and culture—culture influences that which survives and flourishes, and nature influences what is more or less malleable.

On Conscious versus Unconscious Action

Here Mises has been overtaken by recent trends in neuroscience, for he states, "Conscious or purposeful behavior is in sharp contrast to unconscious behavior, *i.e.* the reflexes and the involuntary responses of the body's cells and nerves to stimuli" (M, p. 10). He wants to claim that human action is consciously purposeful. But this is not a necessary condition for his system. Markets are out there doing their thing whether or not the mainspring of human action involves self-aware deliberative choice.

He vastly understates the operation of unconscious mental processes. Most of what we know we do not remember learning, nor is the learning process accessible to our conscious experience—the mind. A normally developing child has learned a syntactically correct natural language by the age of four, without having been taught. As noted by Pinker, "Children deserve most of the credit for the language they acquire. In fact we can show that they know things they could not have been taught" (Pinker 1994: 40). Even important decision problems we face are processed by the brain below conscious accessibility. This is apparent when you are struggling with a decision, or trying to solve a problem, then go to bed, and wake up having made significant progress or found the solution. As the neuroscientist, Michael Gazzaniga, has noted with characteristically plain prose:

> By the time we think we know something—(namely that) it is part of our conscious experience—the brain has already done its work.

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> It is old news to the brain, but fresh to "us" (the aware mind). Systems built into the brain do their work automatically and largely outside of our conscious awareness. The brain finishes the work half a second before the information it processes reaches our consciousness. . . . We (that is, our minds) are clueless about how all this works and gets effected. We don't plan or articulate these actions. We simply observe the output. . . . The brain begins to cover for this "done deal" aspect of its functioning by creating in us the illusion that the events we are experiencing are happening in real time—not *before* our conscious experience of deciding to do something. [Gazzaniga 1998: 63–64].

Indeed, one of the puzzles of neuroscience is why the brain fools the mind into believing it is in command of mental activity. But none of this changes the import of Mises' argument. Markets are one of the social brain's means of extending its capacity for information processing to other brains, and to leverage the creation of wealth beyond anything that can be comprehended by the mind. Just as most of what the brain does is inaccessible to the mind, so also is there a widespread failure of people to understand markets as self-organizing systems, coordinated by prices for cooperative achievement of gains from exchange, without anyone being in charge. The workings of the economy are as inaccessible to the awareness of its agents, business persons included, as is an agent's awareness of his own brain functioning. The workings of the economy are not the product, nor can they be the product, of conscious reason, which must recognize its own limitations and face, in the words of Hayek, "the implications of the astonishing fact, revealed by economics and biology, that order generated without design can far outstrip plans men consciously contrive" (Hayek 1988: 8).

On Brain Circuit Specialization to Discern Opportunity Cost, and the Reason-Emotions Nexus

A persistent theme throughout Mises is that choice is based on a thinking, reasoning person's preference comparisons and judgments of what is more, or what is less: "Action is an attempt to substitute a more satisfactory state of affairs for a less satisfactory one. . . . Cost is equal to the value attached to the satisfaction which one must forego in order to attain the end" (M, p. 97). "Man alone has the faculty of transforming sensuous stimuli into observation and experience, [and can arrange them] into a coherent system. Action is preceded by thinking" (M, p. 177).

I want to call attention to the fact that a line of animal and human research going back to the same year *Human Action* was published

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demonstrates the basis for forgone value comparisons in how the animal brain naturally works. Zeaman (1949) reported experiments in which rats were trained to run to a large reward–motivated goal. Then they were shifted to a small reward, and the rats responded by running more slowly than they would have to the small reward only. A second group of rats began with a small reward and shifted to a large one, and these rats immediately ran faster than if the large reward alone had been applied. This early experiment was consistent with the hypothesis that motivation was based on relative reward—opportunity cost—and not on an absolute scale of values generated by the brain. But this interpretation was not appreciated at the time. Since then, direct measurement of brain neuronal activity has revealed the importance of relative value comparison in how mammalian brains actually work. Thus both monkey and rat brains respond to differential comparisons of rewards. "Neurophysiological studies of both monkeys and rats show that neurons in the six-layered parts of the orbitofrontal cortex (above the eyes) process motivating events, discriminate between appetitive and averse conditional stimuli and are active during the expectation of outcomes" (Tremblay and Schultz 1999: 704).

It is now established that orbitofrontal neuron activity in monkeys enables them to discriminate between relative rewards that are directly related to the animals' relative preference among rewards such as raisins, apple, and cereal (in order of decreasing preference). Thus, neuronal activity is greater for raisins than for apple when the subject is viewing raisins and apple, and similarly when apple and cereal are compared. But the activity associated with apple is much greater when compared with cereal than when it is compared with raisins. This is contrary to what one would expect to observe if the three rewards were coded on a fixed scale of physical properties rather than a relative scale (see Tremblay and Schultz 1999: 706, fig. 4).

Since the technologies used in animal studies are too invasive to be applied to humans, what is the significance for humans of these accounts of how the animal brain works? The answer is that other research has shown that the orbitofrontal cortex in humans and monkeys performs many of the same generic functions. This is indicated by studies of humans and monkeys with damage to this tissue: both species exhibit altered expression of reward and preferences, and impairment of their decisionmaking, motivational, and emotional behavior, which leads to significant abnormalities in social behavior. As noted by Damasio in summarizing this literature: "In spite of the marked neurobiological differences between monkey and chimpanzee, and between chimpanzee and human, there is a shared essence to

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the defect caused by prefrontal damage: Personal and social behavior is severely compromised" (Damasio 1994: 75).

People like to believe that good decisionmaking is a consequence of the use of reason, and that any influence that the emotions might have is antithetical to good decisions. What is not appreciated by Mises and others who similarly rely on the primacy of reason in the theory of choice is the constructive role that the emotions play in human action. For example, Bechara et al. (1997) have studied the behavior of patients with front lobe damage in decisionmaking experiments under uncertainty, and compared their behavior with normal subjects.[1] They show that normal subjects, as they learn about the experimental environment, enter a critical transition in which they change their decision pattern. But *prior* to the switch in decision, skin conductivity tests record an emotional response, whereas only *after* the decision change are they able to articulate verbally why they made the change. Hence, the emotional brain acts prior to the change in decision, while reason, in the form of verbal rationalization, occurs after the decision. The brain-damaged patients, however, fail to show the emotional response, fail to change their decisionmaking, and offer verbal excuses for their poor performance. Interestingly, a generic problem with the patients in their life history is a tendency to lose their jobs, go bankrupt, and have difficulty making satisfactory long-term decisions. Bechara et al. (1997) believe that there are unconscious cues from the emotional brain (sometimes called the limbic system) that guide or influence the formation of cognitive strategies, and that this circuitry is effected by front lobe lesions. Consequently, the emotions, far from being inimical to rational decision, may be essential to it, while the conscious reasoning brain is the last to know.

[1]The subjects' task is to build up their stock of cash by turning over cards from any or all of four decks. The cards in decks A and B yield $100, and in C and D $50. In the former, however, there appears an occasional card with a large, unpredictable loss. The penalties continue with no pattern, nor do the subjects know when the task will end. All subjects are connected to skin electrodes to measure their galvanomic skin response (GSR). Emotional response to events causes humans to perspire more, and this is registered in the form of higher skin conductivity, as measured by a higher galvanometer reading. The first interesting result of the experiment is that there was an emotional response detected in the GRS readings of normal subjects prior to their decision to switch from decks A and B to decks C and D. Only then, following the change in their decisionmaking, were the subjects able to articulate verbally why they were switching. The second important observation is that the patients with front lobe lesions did not switch to decks C and D, there was no associated change in GSR readings, and they tended to offer verbal excuses as to their poor performance, some indicating that decks A and B might get better.

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On Human Society and Cooperation

According to Mises, all social relationships arise from the division of labor, which is made possible by the market economy:

> Within the frame of social cooperation there can emerge between members of society feelings of sympathy and friendship and a sense of belonging together. These feelings are the source of man's most delightful and sublime experiences. They are the most precious adornment of life. . . . However, they are not . . . the agents that have brought about social relationships. They are the fruits of social cooperation, they thrive only within its frame. . . . The fundamental facts that brought about cooperation, society, and civilization and transformed the animal man into a human being are the facts that work performed under the division of labor is more productive than isolated work and that man's reason is capable of recognizing this truth [M, p. 144].

I want to put an altogether different spin on these issues, without, I think, denying, or detracting from, the main import of Mises' message. My version, based upon archeological, ethnographic, and experimental studies, offers a different perspective on the social psychological origins of exchange, property rights, and money. Since I have already developed this theme elsewhere, I will use this opportunity to update and restate it in the context of honoring Mises' lasting contributions (Smith 1998).

Perhaps second only to language as a human universal, people continually, and to a large extent unconsciously, engage in reciprocity with friends, associates, and even strangers if the context is not perceived to be hostile. You invite acquaintances to dinner, and subsequently they invite you. You give your theater tickets to a friend when you are out of town, and subsequently she gives you concert tickets that she is unable to use. Friends trade favors, lend property, and provide services to each other autonomically, without a close keeping of accounts. Hence, the common phrase, "I owe you one." Hunter-gather societies studied in the last 100 years are replete with social exchange systems that have far-reaching economic implications. Although some have forms of commodity money, many have none and rely entirely on social exchange through reciprocity to capture gains from exchange in a world without money or refrigeration. The forms of institutions vary widely, but their functionality is the same. There is a pronounced division of labor across generations and between the sexes: generally women, children, and older men gather and process plant food; men and boys beyond the age of 18 hunt; older men advise in hunts and make tools; and grandmothers assist in the birthing and rearing of children as part of a characteristically human

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biological adaptation—menopause, leading to an extended postreproductive life of family and community service.

This "instinct" for reciprocity has surfaced strongly and unexpectedly in various extensive form laboratory experiments (Fehr, Gächter, and Kirchsteiger 1996; McCabe, Rassenti, and Smith 1996). As indicated above, experimental market research strongly corroborates the Smith-Hayek-Mises theme of cooperation through market institutions in which property rights harness self-interest to create wealth. But up to one-half or more of the same subjects who unknowingly maximize the gains from exchange in anonymous interaction through a set of market rules also choose to forgo action in the self-interest to achieve cooperative outcomes through trust and trustworthiness in anonymous interactions in simple complete information games.

For example, in one of the trust games 12 subjects arrive at the laboratory to "earn money in an economics experiment." As individuals arrive they are paid $5 for appearing on time and are assigned a computer terminal in a room containing 40 machines separated by partitions. After all subjects arrive they log in, and each is randomly and anonymously paired with another subject in the room, and is randomly assigned the position of first, or second, mover.

The game is played once. The first mover can elect to split $20 evenly, $10 for himself, $10 for player 2. Alternatively he can pass to player 2, which doubles the original pie to $40. Player 2 has two options: take the $40, leaving nothing for player 1, or take $25, leaving $15 for player 1. Whatever the choice, at the end each subject is paid privately, and leaves the experiment. The entire experiment takes about 15 minutes. No subject knows with whom he or she is paired. This single play, anonymous matching, protocol is widely acknowledged to define the conditions most favorable to noncooperative moves by each player. Game theory assumes that in the absence of repeat play, or any history or future interaction between the players, each will choose dominant strategies, and each will assume the other will so choose. Consequently, the equilibrium (subgame perfect) of the game is for the first mover to take $10, leaving $10 for player 2. Otherwise, if the first mover passes the second mover will choose to take the entire $40.

Alternatively, suppose player 1 is a person whose policy in interacting socially with others is often to initiate a friendly exchange. In this context passing the move to player 2 is intended as an offer that they cooperate. Player 1 risks an opportunity loss of $10 for an opportunity gain of $5. This can be interpreted as a signal to player 2 implying that "I am not giving up the sure thing of $10 because I expect you to leave me with 0; I am offering you a 250 percent return, so that

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I can get a 150 percent return from the exchange. I am trusting you to be trustworthy." If player 2 is similarly disposed, we have a trade, yielding gains from exchange in which player 1 receives $15 and player 2 receives $25.

Table 1 lists the outcomes for a sample of 24 pairs of undergraduates and a sample of 28 pairs of advanced graduate students. (Data from McCabe and Smith 1999; also see Gunnthorsdottir, McCabe, and Smith 1999). The lesson is that half of the sample of university students, including advanced graduate students from across the United States and Europe, with training in economics and game theory, are trusting, while some 64 to 75 percent of their matched counterparts are trustworthy. Why does such a large proportion of these anonymously interacting subjects forgo noncooperative self-interested action as predicted by game and economic theory? We think the reason is simple: most people in relatively stable societies find it pays, in the long term, to show a cooperative, accommodating face to their fellow humans. This accustomed stance is so strong that it survives even in an unfamiliar anonymous-interaction experimental game played once; most of their paired counterparts get the message, and reciprocate to their mutual advantage. Our data show that players 1 who cooperate, risking defection, on average make more money than those who do not cooperate.

I want to suggest that this sort of behavior has been characteristic of our ancestors in developing form, probably for the last 2 million years. In fact I would agree with Mises that it was through exchange that we got to where we are today, except that for most of our history, exchange occurred through reciprocity in the family, the extended family, and the tribe. This is what laid the basis for the earliest specialization, long before markets arose. Consequently, when someone invented barter, and later what would be called "money" (no

TABLE 1

NUMBER (PERCENTAGE) OF PAIRS ACHIEVING INDICATED CONDITIONAL OUTCOME BY SUBJECT POOL TREATMENT

Outcome	Undergraduates	Advanced Graduate Students
(10, 10)	12 (50%)	14 (50%)
(15, 25)[a]	9 (75%)	9 (64.3%)
(0, 40)[a]	3 (25%)	5 (35.7%)

[a]Number of pairs achieving this outcome conditional on reaching the second stage of the game (player 1 passes). Thus, with the undergraduates, 12 of 24 players 1 moved down, of which 9 players 2 moved right and 3 moved down.

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doubt like language it was "invented" many times over), humans already had a vast experience with *social* exchange. What money enabled was a freeing of the mind from goodwill accounting—the need to periodically check to see that your goodwill account with a friend was not too much out of balance. This new element would have made long-distance trade possible, which has culminated today in world markets, and the initiation of the age of electronic commerce (North 1991).

The above model of the individual—to behave noncooperatively in impersonal markets and maximize the gains from trade, but cooperatively in personal exchange also to maximize the gains from exchange—enables one to understand why people keep wanting to intervene in markets to "improve" matters. *Their experience in personal social exchange is that doing good* (by being trusting and trustworthy) *accomplishes good* (visible gains from social exchange). In impersonal exchange through markets, the gains from exchange are not part of their experience. As noted by Adam Smith ([1776] 1909: 19), "This division of labour . . . is not originally the effect of any human wisdom, which foresees and intends that general opulence to which it gives occasion." Impersonal exchange through markets tends to be perceived as a zero sum game, which perception in no way diminishes the capacity for markets to do the work articulated by Adam Smith and Mises. Interventionist programs, I suggest, result from people inappropriately applying their intuition and experience from personal social exchange to markets, and concluding that it should be possible to intervene and make things better. People use their intuition, not their reason (as hoped by Mises), in thinking about markets, and they get it wrong.

Conclusion

Two characteristics, unique to the hominid line, are most likely central to the emergence of specialization (the extended order of cooperation), as a human universal allowing our protohuman ancestors to "have dominion over the fish of the sea, and over the fowl of the air, and over the cattle, and over all the earth, and over every creeping thing" (Genesis 1:26). These two are: (1) the use of a sophisticated natural language; and (2) reciprocity, or "the propensity to truck, barter and exchange one thing for another" (Smith [1776] 1909: 19). It is hard to imagine that these two characteristics evolved independently. They are almost certainly part of a coevolutionary cultural and biological nexus going back over 2 million years. The instinct for exchange

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explains the survival of trading systems in China, the former Soviet Union, and elsewhere under state, and attempted social, repression.

Mises and Hayek articulated and vastly enriched the principles of Adam Smith at a crucial time in this century, when their thinking was widely rejected as anachronistic, unworkable, and ideological. They spoke for freedom when it was without popular support; they spoke with insight and wisdom. But they spoke from independent, sometimes contradictory, perspectives. For Mises, "reason . . . is the mark that . . . brought about everything that is specifically human" (M, p. 91). But for Hayek the fatal conceit is "the idea that the ability to acquire skills stems from reason. For it is the other way around: our reason is as much the result of an evolutionary selection process as is our morality," but it stems from a separate development—"one should never suppose that our reason is in the higher critical position and that only those moral rules are valid that reason endorses" (Hayek 1988: 21). "To understand our civilization one must appreciate that the extended order (of cooperation) resulted not from human design or intention but spontaneously: it arose from unintentionally conforming to certain traditional and largely *moral* practices many of which men tend to dislike, whose significance they usually fail to understand, whose validity they cannot prove, and which have none the less fairly rapidly spread by evolutionary selection—the comparative increase in population and wealth—of those groups that happened to follow them" (Hayek 1988: 6).

Even though Hayek, in my view, is the leading economic thinker of the 20th century who saw what must be the mainsprings of the extended order, Mises was the choice technician, and no one was better at articulating the primacy of the individual and the need to define and nurture individual rights. Experimental economics, created in the 50 years since *Human Action,* is kind to the Austrians in enabling us to demonstrate that the spontaneous order, operating through property right institutions, exhibits the desirable characteristics that the Austrians claimed for it. This power of demonstration is for me far more compelling than the appeal to reason, especially by Mises. Reason, after all, is also claimed to be on the side of state intervention, and that form of reason has a way of commanding people's minds because of its superficial correspondence with their experience, even as the systems created by it crumble about them, and they despair that all would be well if humans were not so greedy.

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The Methodology of *Human Action*

Lawrence H. White

Vernon Smith has given us a very interesting set of reflections on Mises' *Human Action*. In the area of methodology, *Human Action* might be regarded as a statement of dedicated apriorism, while Smith might be regarded as a dedicated empiricist (of the experimentalist variety). Considering that, Smith displays surprising and commendable open-mindedness toward the book.

Ethical Neutrality and Rationality in Economics

Mises (1966: 19), quoted by Smith, declares that "Human action is necessarily always rational." Smith tells us that Mises considers this true "because praxeology is neutral with regard to any value judgments concerning its data—that is, the ultimate ends chosen in human action. Hence, there is no objective basis for asserting that anyone's choices can be irrational." I believe that Smith's "because" is misplaced. Although the paragraph Smith quotes does discuss both the necessary rationality of human action and the ethical neutrality of praxeology, the latter is not the reason for the former. We should not blur two distinct issues: (1) the meaning of the term "rational" in economics, and (2) the ethical neutrality of economic analysis (*wertfreiheit*).

Ethical neutrality means that economics is concerned with tracing the consequences of market activity and economic policy, not with judging them for goodness and badness. To be *rational*, for Mises (1966: 20), is to engage in purposeful behavior, that is, to deliberately attempt to attain some goal. Further, "action" means "purposeful behavior" (Mises 1966: 11). The only nonpurposeful (non-goal-oriented) behavior is reflexive behavior. Thus *by definition* all human "action" is "rational," whether or not one accepts *wertfreiheit*. (In

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the sentence following the declaration quoted by Smith, Mises thus continues: "The term 'rational action' is therefore pleonastic and must be rejected as such.") One could accept Mises' terminology, and still reject *wertfreiheit*, believing that economics has an ethical mission to judge decisions for goodness or badness. The two issues only *seem* to overlap when the terms are used differently, in particular when an observer describes a person's decision as "irrational" when he means "bad" or "contrary to my (the observer's) goals." Mises discusses ethical neutrality in order to warn against this usage, not in order to explain why human action is necessarily rational.

Economics Is Not a Natural Science

Smith soon begins to offer constructive criticism: "There is plenty in Mises to update because of things we think we know now that we did not know 50 years ago," specifically about "the nature of human decisionmaking." Our new knowledge about decisionmaking comes from (1) Smith's own incentive and "market" choice experiments with human subjects; (2) anthropology, ethnography, and evolutionary psychology; and (3) neuroscience research—for example, on monkey brains and damaged human brains.

It is easy to agree that any statement made 50 years ago about the state of the natural sciences is likely to require updating. I agree with Smith that Mises was wrong, or at least far too sweeping, when he wrote (Mises 1966: 31): "No laboratory experiments can be performed with regard to human action." In fairness to Mises, though, this statement came in the middle of a paragraph about the problem of explaining historical experience. Mises was simply pointing out that economic history does not take place in a laboratory setting, so that methods other than controlled experiments must be used to establish causal explanations of historical human actions. Historical data are not laboratory data.

Smith's criticism suggests an important larger issue for anyone who takes seriously the Misesian project of "praxeology" (the aprioristic derivation of economic theory, beginning with the pure logic of choice). Do Mises' views on the proper methods of economics require updating? I would argue that they do not. I think Mises is still correct in insisting that the core propositions of economic theory are rooted in methods distinct from those of natural science. Praxeology is independent of natural science, and experimental economics in this respect counts as a natural science. This does not mean that experimental economics does not belong in an economics department, or is uninteresting or irrelevant to how we nonexperimentalists do economics.

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There is plenty of room for both praxeological and natural-scientific approaches to human behavior in markets.

My position boils down to this: experimental economics and other natural sciences are not in a position to falsify the deductive propositions of economic theory. These propositions rely on our "internal" perspective on human beings as agents, whereas natural science gives us an "external" perspective on human beings. Experiments *can* illustrate or "demonstrate" the working of economic theory. In Smith's words, they can "bring to life" its "imaginary constructions." Most importantly, they can help to settle important questions that cannot be settled aprioristically. The set of such empirical questions is not empty (nor did Mises believe it was). On the other hand, neither is the set of useful deductive economic propositions empty. It includes not only consumer theory but also some of monetary theory (for example, Gresham's Law).

Entrepreneurial Discovery

Smith says that current neuroscience refutes Mises' view that there is a "sharp contrast" between purposeful behavior and unconscious or reflexive or involuntary behavior. I have no doubt that, from the viewpoint of neuroscience, there is a continuum rather than a sharp contrast. But I must disagree when Smith says that purposiveness "is not a necessary condition for his [Mises'] system. Markets are out there doing their thing whether or not the mainspring of human action involves self-aware deliberative choice." Smith's statement might apply to Walras's theoretical system, of which I believe it was Pareto who said, "the individual may disappear, provided he leaves us with a photograph of his tastes." But it is does not apply to Mises' theoretical system. Mises' understanding of the way the market process really works is that of an entrepreneurial discovery process, not of mere homeostatic responses to stimuli. That the resulting social order is unintended does not imply that the individual decisions comprising it need not be deliberative.[1]

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[1]On this issue, see the classic exchange between Becker (1962, 1963) and Kirzner (1962, 1963).

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Mises and His Understanding of the Capitalist System

Israel M. Kirzner

To someone not familiar with Ludwig von Mises' understanding of the market, there would, on the surface of Mises' exposition, appear to be a puzzling tension in that exposition—a tension having to do with some very basic elements of Mises' position. We shall find that the resolution of this tension is, once it has been explained, fairly obvious, but we shall also find that a careful consideration of this resolution can help us more fully appreciate the uniqueness (and the intellectual integrity) of Mises' understanding of the capitalist system.

A Tension within Mises' Economics?

The apparent tension in Mises to which we refer relates to the nature and significance of the market prices for inputs and outputs that emerge at each moment in the real world. These actual market prices are described by Mises as reflecting an "equilibrium of demand and supply"; they actually equalize "the size of the demand" with "the size of supply"; in the "unhampered market," any "deviation of a market price from the height at which supply and demand are equal is"—apparently instantaneously—"self-liquidating" (Mises 1966: 762). It is on this basis that Mises pronounces any government interference with market prices of commodities or resource services (including wage rates)—that is, any requirement that a price at a given date be different from the value which the unhampered market would have generated for that date—as disturbing the "equilibrium of demand and supply," and, therefore, in general, as producing results that are (from the perspective of the government) worse, not better, than the conditions the government wished to improve.

Joseph Salerno (1993: 121) has interpreted this Misesian position to mean that all market prices are "market-clearing prices." "The

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constellation of resource prices that emerges on a market unhampered by legal restrictions *always* reflects the circumstance that existing resources are devoted to their most valuable uses as determined by entrepreneurial appraisements of future output prices." The impression conveyed here is that actual market prices are, in the relevant sense, the "correct" prices, the prices that ensure that resources are channelled to their most valuable uses. Interference with those prices necessarily obstructs the efficiency with which the market allocates resources.

And yet, on the other hand, Mises is clearly entirely aware that the market prices at any given date are almost certainly *not* the "correct" prices. In Salerno's words, market prices are, as a consequence of the unavoidable errors of entrepreneurial judgment under uncertainty, "also disequilibrium prices" (Salerno 1993: 121). In Mises' own words, the market prices at any given date are, in contrast to the imaginary prices that would characterize the imaginary "final state of rest," seen as "*false* prices" (Mises 1966: 245, 338). It is the market process, driven by the competition of profit-seeking entrepreneurs, that modifies those false prices and tends to ensure that they are replaced by prices more closely and "truthfully" reflecting the underlying preferences of the consumers. What stimulates that process is the realization by entrepreneurs that the existing market-generated pattern of resource allocation is not the ideal one. There is, in fact, "a discrepancy between what is done and what could be done" (Mises 1966: 336).

One can surely sympathize with the beginner-reader of Mises who finds himself puzzled by these statements, which seem, when taken together, to claim that actual market prices are the correct (equilibrium) prices, but that they are also false (disequilibrium) prices—that the pattern of resource allocation actually achieved at any given date is optimal, but is, at the same time, not at all as efficient as it might be.

Tension Resolved

A more mature student of the Misesian system is able to reassure such a puzzled beginner. There is no internal tension in Mises' exposition. What needs to be understood is the distinction between what Mises (1966: 244–45) calls "the plain state of rest" (or simply "the state of rest"), on the one hand, and what he calls the "final state of rest" (a state not identical with, but closely related to Mises' concept of the "evenly rotating economy"—the Misesian concept that is the closest to standard Walrasian general equilibrium [see Mises 1966: 246–47]), on the other. It is not our purpose here to elaborate on

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Mises' "final state of rest" or on his "evenly rotating economy." What we wish to do is to clarify key aspects of Mises' "plain state of rest."

For students coming to Mises from a background in standard microeconomic theory, it is easy to view Mises' "plain state of rest" as corresponding to the mainstream short-run equilibrium state. That error might lead students to interpret Mises' statements concerning the "equilibrium of demand and supply" in a particular market as corresponding to the conditions prevailing at the intersection of the Marshallian demand and supply curves. But such an understanding would be quite mistaken. The Marshallian intersection refers to a state of affairs in which all participants (and all potential participants) in a specific market have somehow become aware of that price which is capable of clearing the market, and have correctly anticipated that that price would indeed prevail in this market. A price that "clears the market" means, in this mainstream sense of the term, one that ensures that all those who might—were they to be informed as to this prevailing price—be prepared to sell (buy) are, in fact, so informed and are able to find buyers (sellers) willing to accept their offers to sell (buy) at this prevailing price. Mises' "plain state of rest" does not entail any such assumptions concerning the state of information. His plain state of rest "comes to pass," in the real world, "again and again": "At any instant all those transactions take place which the parties are ready to enter into at the realizable price." "When the stock market closes, the brokers have carried out all orders which could be executed at the market price" (Mises 1966: 244). Clearly, such a state of rest (which, as Mises emphasizes, "is not an imaginary construction" but a state achieved repeatedly in the real world) refers to the completion of transactions between only those who are aware of the existing situation. The "supply and demand" that are continually in equilibrium in Mises' world do not refer to the supply and demand schedules so basic to mainstream microeconomic theory. They refer simply to the circumstance that, in any situation, those potential transactors who have been aware of available mutually beneficial trade possibilities will have moved to take advantage of those opportunities. Of course, once those opportunities have been grasped, market activity ceases, and the "plain state of rest" has been attained.

To describe the price emerging from those exchange transactions as a "market-clearing price" (Salerno 1993: 121) is therefore misleading. Certainly the price permits all those who stand to gain by exchanging at that price—and who are aware of it—to exchange to the point where no known remaining mutually gainful opportunities exist. But the term "market-clearing price" (a term not used by Mises) is used in standard economics to refer to the exhaustion of all mutually gainful

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exchange opportunities *under the hypothetical conditions of (relevant) omniscience.* Standard economics indeed notoriously proceeds, in applying supply and demand theory to the real world, to operate *as if* conditions of relevant omniscience can be taken as given. Mises is certainly not making any such assumption of omniscience. His market prices are certainly *not* "market-clearing prices" (in the usual sense of that term). There is, one is able to reassure the puzzled reader, therefore no contradiction in his exposition. Real-world market prices are *not* the equilibrium prices of standard economic theory. (Real-world prices relate to equilibrium only in a very narrow sense, a sense to which no attention at all is given in standard theory.)

Real-world prices are indeed likely to be "false" prices, setting off entrepreneurial-competitive activity modifying the pattern of resource allocation. The real-world pattern of resource allocation at any given moment can be described as optimal only relative to existing *information in fact possessed by entrepreneurial market participants.* The tension in Mises is quite imaginary; it is perceived—quite understandably and reasonably perceived—only as a result of reading Mises through the spectacles acquired in studying mainstream economics.

But this resolution of the puzzle should itself surely raise a different puzzle of its own. It would appear, if one accepts the above interpretation of Mises, that Mises' references to what is achieved every day in the market must, while certainly true, strike any economist as being merely *trivially* true. The optimality achieved every day in the market is optimality only within the extremely narrow framework relevant to real-world conditions. All those aware of the opportunities for mutually gainful exchange, which are, in fact, available, take advantage of these perceived opportunities. To recognize this truth may be an achievement for someone who had not previously understood the significance (and mutual gainfulness) of interpersonal exchange. But this has little to do with the central insight that all economists share concerning the effectiveness of markets in tending to stimulate the exhaustion of *all possible* opportunities for mutually gainful exchange. Here we must of course proceed, with Mises, to recognize that the market prices at any date are surely "false" prices, prices that generate entrepreneurial activity likely to cause those false prices to change. Certainly Mises clearly understood and expounded the competitive entrepreneurial process that continually tends to replace "false" prices by more "truthful" prices. But, then, one can only ask, what is the point of emphasizing the apparently trivial Misesian insights concerning what is *actually* achieved every day in the "plain state of rest"?

The purpose of this paper is to argue that, in emphasizing these apparently trivial insights, Mises revealed his unique understanding

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of what is achieved in the capitalist system. To appreciate this, it will be helpful to refer to the pioneering vision of the founder of the Austrian tradition, to Carl Menger. It is perhaps worthwhile recalling that Mises, referring to his first reading, in 1903, of Menger's *Grundsätze*, remarked that "it was the reading of this book that made an 'economist' of me" (Mises 1978: 33).

The Vision of Carl Menger

Menger is usually recognized as one of the three pioneers of marginal utility economics, offering economists a theory of subjective value.[1] But, in regard to a subjective theory of value, the claims made on behalf of Menger's originality are somewhat clouded. As Erich Streissler (1990) has shown, there were German economists of the early 19th century, with whose works Menger was unquestionably familiar, whose value theory had incorporated subjective insights long before Menger. Yet Menger certainly believed that his *Grundsätze* was breaking entirely new ground. Friedrich Hayek (1934: 16) has told us that Menger "is said to have once remarked that he wrote the *Grundsätze* in a state of morbid excitement."

What appears to have happened was that Menger glimpsed, at least, a grand perspective on the functioning of the entire market system that contrasted radically with the still dominant Ricardian way of seeing that system. For the Ricardian vision, the size and rate of growth of aggregate output, and the pattern of its distribution among the factor classes that produce it, are inexorably determined, at least in the long run, by objective, physical realities. In the explanation of such determination there is no place for any roles for human resourcefulness, human valuation, human expectations, human discoveries.

Menger, on the other hand, glimpsed a way to understand economic history in diametrically opposite terms. For this view, the physical and biological realities recede into the background; it is the impact of the actions of human beings that *alone* actively determines the course of human events. It was this revolutionary new vision that, I suggest, was responsible for the "morbid excitement" with which Menger wrote his book. And this was a vision that had certainly not been shared by the early 19th century German pioneers in the subjective theory of value, to whom Streissler has referred.

It was Menger, rather than any forerunners, who (already in his 1871 book) recognized that it is the consumer valuation of output

[1]The ideas briefly presented in this section have been developed more fully by the writer in his editorial Introduction to volume one of Kirzner (1994).

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that tends to be reflected in the market prices of the relevant inputs—which Menger identified as "higher order goods"—making Menger a pathbreaker in the development of neoclassical marginal productivity theory. It was this insight that drew the attention of the profession to the truth that the importance of the means needed to achieve specific ends is governed entirely by the importance attached to those ends. This is not merely an insight demolishing cost theories of value; it is an insight that introduces a new understanding of economic causality throughout the economic system. Every act of production, every market transaction, is set in motion and wholly governed by consumer preferences. Armed with this radical—and quintessentially "Austrian"—vision of Menger, we may return to Mises and his understanding of the capitalist process.

Mises and the Doctrine of Consumer Sovereignty

The concept of "consumer sovereignty" entered into economic terminology, it appears, largely as a result of the work of the late William H. Hutt (see Hutt 1936: chap. 16, and 1940).[2] This concept became central to Mises' understanding of the market economy. I shall argue that, in emphasizing this centrality, Mises was simply pursuing the Mengerian vision discussed in the preceding section.

In *Human Action*, one section of chapter 15 ("The Market") is entitled "The Sovereignty of the Consumers." In that section (a mere two pages, in a 900-page treatise) Mises presented his own vision of the capitalist process. He explains that while entrepreneur-producers directly control production and "are at the helm and steer the ship," they are not supreme; the "captain is the consumer." "Neither the entrepreneurs nor the farmers nor the capitalists determine what has to be produced. The consumers do that" (Mises 1966: 270). "A wealthy man can preserve his wealth only by continuing to serve the consumers in the most efficient way." So that "the owners of the material factors of production and the entrepreneurs are virtually mandatories or trustees of the consumers" (Mises 1966: 271). (Mises finds only one instance—the case of monopoly—where the wishes of the consumers can be flouted. We shall, later in this paper, pay a good deal of attention to this exception to the general rule of consumer sovereignty.)

In *Human Action* not much further attention is paid to the idea of consumer sovereignty, but there can be no doubt as to its centrality for Mises' understanding of the market economy. I vividly recall Mises'

[2]Hutt used the term "consumer sovereignty" fairly frequently in his papers of the mid-1930s, (see e.g., Hutt 1935; reprinted as chapter 12 of Pejovich and Klingaman 1975).

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continually repeating, in his lectures and seminar presentations, that consumers control the pattern of production by their decisions to buy or to refrain from buying. A glance at the index to a volume of Mises' more popular and shorter pieces (Mises 1990) reveals how frequently the idea of "consumer sovereignty" shaped his thinking, especially in his later years.

There is no doubt that, in emphasizing the supremacy of consumers in the market economy, Mises was often seen as going beyond the role of positive scientist and appealing to widely shared judgments of value. But, in fact, for Mises the doctrine of consumer sovereignty was much more fundamental and significant than its being a normative application of positive economics. The doctrine of consumer sovereignty was, in its own right, an important part of positive economics; it was a scientific theorem marking the completion of Menger's vision. What happens in markets is that consumers shape the pattern of resource use and the assignment of resource rewards according to their preferences. The outputs being produced at any date, the methods of production being employed, and the rewards being given to the various owners of productively used resources are those dictated by consumers. The consumer is indeed "the captain." This *may* be seen as a desirable feature of the market economy, but for Mises the significant scientific point is simply that consumer sovereignty does in fact prevail. In free markets it is the consumers whose preferences govern every act of production and every transaction involving the purchase and sale of a unit of resource service.[3]

Consumer Sovereignty and the Mutual Benefits Derived from Exchange

In order better to appreciate the meaning and significance of consumer sovereignty, it may be helpful to contrast the doctrine of consumer sovereignty with the doctrine of mutual benefit derived from exchange. The market is often hailed as the arena in which all parties to freely made exchanges benefit (in their own ex ante best judgment)—that is, the market is the social framework permitting and stimulating all possible positive-sum (exchange) games. The recogni-

[3]The late Murray N. Rothbard (1962: 560–66) has sharply attacked Hutt's notion of consumer sovereignty. (Rothbard does not refer to Mises' very frequent references to the doctrine of consumer sovereignty.) However, Rothbard concedes that in a "formal" sense (in which the ultimate goals of producers are recognized as consumption goals) "consumer sovereignty, by definition, always obtains" (Rothbard 1962: 561). There is reason to believe that Rothbard's position is not inconsistent with the interpretation of Mises being presented in this and subsequent sections of this paper.

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tion of this achievement of the market is certainly an important economic insight. It is indeed possible to interpret the entire market process—involving resource markets, processes of production, and product markets—as being simply an elaboration of the central circumstance that all parties to voluntary exchanges are beneficiaries of those exchanges. (There is a solid basis for the conjecture that Walras's more mature expositions of general equilibrium theory, including production, emerged simply as the logical extension of his earlier version of general equilibrium in the pure exchange economy.) But the doctrine of consumer sovereignty, taken in conjunction with what we have described as Menger's vision, permits us to see the overall character of the market process from an entirely different angle. What happens in the market economy is not merely that the owners of resource services and those eager to consume the products (able to be produced with those resource services) are, through the intermediation of entrepreneurial producers, led to mutually beneficial exchanges. What happens in the market economy is that the owners of resource services are led to sell those services to those producers whose production plans are best calculated to cater to consumer preferences. The preferences of consumers determine the uses to which resources are assigned. The market may validly be seen as the arena in which the potential benefits from voluntary exchanges are extracted. But the free market is more fundamentally the arena in which the value scales of consumers come to govern the disposition of potential factors of production.

The Significance of Private Property

For Mises, the doctrine of consumer sovereignty offers an insight into the social role fulfilled by the institution of private property. There is, as a matter of scientific fact, no conflict of interest between the owners of productive resources (whether land or labor power), on the one hand, and the consuming public on the other. *The owner of a productive resource can derive economic benefit from his resource only to the extent that he places it at the service of the consuming public.* As we have already cited from Mises, a "wealthy man can preserve his wealth only by continuing to serve consumers in the most efficient way." The doctrine of consumer sovereignty demonstrates the harmony of interests existing in a market economy between owners of resources and consumers. Recognizing this harmony of interests is merely another way of sharing Menger's vision. It is the circumstance that consumers dictate the allocation of resources that in fact creates

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this harmony of interests. And, of course, it is the institution of private property that permits and stimulates this harmony of interests.

Because entrepreneurs compete in resource markets, inspired by the hope of winning pure profit by redirecting the deployment of resources in ways more satisfying to consumers, we are able to understand how consumers control—and ultimately direct—the pattern of production, the organization of industry, and the allocation of resources among competing industries. But Mises pointed out one situation—the case that he called the "monopoly price" case—in which the doctrine of consumer sovereignty does *not* apply. "Monopoly prices are an infringement of the sway of the consumers" (Mises 1966: 272). For this monopoly price situation, the institution of private property does *not* spell a harmony of interests between the resource owners and the consuming public. For that situation—and *only* for that situation—it might indeed be rational for consumers to invoke political power to modify the outcomes forthcoming from the unhampered market. It was Mises' merit (and a reflection of his intellectual integrity) to identify this case and accord it the scientific attention it deserves. Unfortunately, not all Mises' followers have properly appreciated the place that his theory of monopoly price plays in his overall understanding of the capitalist system.

Mises and the Theory of Monopoly Price

The nature and place of monopoly theory in Mises' system differ radically from the part monopoly theory plays in standard microeconomics.[4] For standard economics, a monopolistic market for a commodity differs from a perfectly competitive market primarily in that the monopolist faces a downward-sloping demand curve, so that the profit-maximizing decision by the monopolist permits him to charge a price that exceeds marginal cost. Standard monopoly theory is thus a theory exploring the peculiarities of decisionmaking by a *producer*. The consequences of monopoly decisionmaking are assessed primarily in terms of the way such decisionmaking may be held responsible for resource misallocation, in regard to the economy as a whole. For the Misesian theory of monopoly price, matters are quite different.

Unlike conventional economists, Mises identified monopoly *at the level of resource ownership*—not, except as a derivative, at the level of the decisions made by producers. For Mises, the possible case of resource monopoly (where the entire supply of a scarce resource is

[4]For further discussion of the Misesian theory of monopoly price (and a critique of some work by followers of Mises who have, in this writer's opinion, not adequately appreciated the Misesian theory), see Kirzner (1991).

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controlled by a single resource owner) is of scientific and normative interest, not in terms of possible "misallocation of resources" (a concept that is not clearly identified in the Misesian system), but, rather, insofar as it may affect incentives in a manner *at variance with the doctrine of consumer sovereignty.* Depending on the degree of elasticity of demand for the monopolized resource, it may be the case that its owner could extract greater revenue from the market by *withholding* (or even destroying) part of the resource stock that he owns than by placing all of it at the service of consumers. He might then charge a "monopoly price" that would enable him to gain by withholding part of his resource stock. If this is indeed the case, then we have an exception to the general rule of consumer sovereignty. We have an exception to the general rule that private ownership of resources results in a harmony of owners' interests with those of the consuming public. We have a case where it is in the interest of a property owner, in effect, to deny consumers the productive capacity of the resources he controls. For Mises the austere, *wertfrei* scientist, such a case is not, by itself, "bad" or "inefficient." It is simply a case that, unlike any other possible situation, pits the interests of consumers against those of a property owner. It would not be irrational, in such a case, for consumers to explore political avenues through which to modify the outcomes that would emerge from the unhampered market.

Because substitute resources are normally available—so that the demand curve for the resource may be sufficiently elastic to make it impossible to gain by withholding part of the resource supply from production—and because entrepreneurs have an incentive to innovate (which would reduce the uniqueness of any particular monopolized resource), Mises did not believe that the case of monopoly price is an empirically important case.[5] But it remains an intriguing theoretical possibility, primarily in its unique property of permitting production to be conducted in a pattern that no longer faithfully reflects the preferences of consumers. It represents the theoretical possibility that, as a result of an accident of the pattern of resource ownership, Menger's vision may be partly inaccurate. Economic phenomena may, in an unhampered market, *not* be shaped exclusively and entirely by consumer demand; sovereignty over production may not reside

[5]Nor, it should be emphasized, is the case of monopoly price one that can be empirically identified and observed. Failure to use all the available supply of the monopolized resource may simply reflect the monopolist's entrepreneurial judgment that future consumer demand may be strong enough to justify postponing its use to the future. Even physical destruction of part of the supply *might* (admittedly far-fetchedly!) be the manner in which the monopolist is expressing his *own* consumer preferences.

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entirely in the preferences of the consuming public but in the ownership rights of one or more resource owners.

As with many theoretical exceptions to generally prevailing patterns, the case of monopoly price seems of importance, for the Misesian system, not so much in the intriguing possibility that it itself represents as in the light it throws on the more general pattern—that to which Menger's vision and the doctrine of consumer sovereignty do apply. Indeed, now that we understand the sweeping generality of the doctrine of consumer sovereignty, we can perhaps better understand certain aspects of Mises' system which, at the outset of this paper, we found mystifying.

Mises, Market Prices, and Consumer Sovereignty

It will be recalled that Mises made certain assertions concerning the prices that prevail in real-world markets, which we found puzzling. Those assertions attributed apparent optimality properties to these prices, and to the transactions to which they give rise. We were able to establish that Mises understood that the market prices of any given date are likely to be *false* prices, generating corrective entrepreneurial-competitive production activity. But we were left mystified regarding the sense in which the everyday market prices (and the transactions to which they give rise) can be pronounced the "correct" prices, prices consistent with an "equilibrium of demand and supply." Surely, we asked, the simple insight that, in any market, exchanges benefit all parties to them (in their own best estimation)—and the related insight that, to the extent that potential beneficiaries are aware of the possible opportunities arising from exchange, they can surely be relied upon to take advantage of them—is too simple, almost too trivial, and too limited to permit Mises to denounce any governmental interference as counterproductive. Perhaps the insights we have gained in the preceding sections of this paper can help demystify Mises' position.

Once we have understood the central position of the doctrine of consumer sovereignty in Mises' overall system, we can surely sense and appreciate the deep respect Mises felt for the actual market prices of productive resources. Certainly these prices are likely to be "false" prices, in that they necessarily imperfectly anticipate the true future valuations of consumers for the various possible potential products (at the times when these products might conceivably be made available to consumers). Nonetheless, these prices, and the transactions in which they emerge, are wholly governed—of course, ignoring now the special exception of the monopoly price case—by the preferences of consumers. These prices and these transactions fulfil Menger's

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vision: they express consumer sovereignty. Mises would of course not deny that, in the absence of omniscience, actual prices and actual plans for production may only imperfectly reflect the patterns of intensity of consumers' preferences. But "sovereignty" need not imply that the wishes of the sovereign are instantaneously and successfully carried out. It may surely mean that each act of those directly or indirectly acknowledging that sovereignty is motivated by the incentive of fulfilling those wishes as far as human effort and human will can succeed in doing. Even the mistakes that may occur under pressure of this incentive must be attributed to the supremacy of the sovereign.

Surely, Mises' profound insight into the character of the capitalist market process was that, at every moment, the decisions made by entrepreneur-producers and resource owners are directly or indirectly made under the powerful incentive to cater to the true pattern of consumer preferences. Each market price for a resource directly reflects the judgments of competing entrepreneurs as to the most valuable use—valuable as judged by anticipated consumer willingness to pay—to which that resource can be assigned. Each production plan that is initiated at any given moment expresses the judgments of competing entrepreneurs (acting in the light of the resource market prices of the moment and in the light of their anticipations of the market prices for future products) as to the most effective ways of deploying productive resources in the service of satisfying consumer preferences.

The near certainty that hindsight will reveal the "falsity" of present prices and the "inefficiency" of present production plans does not in the slightest degree cast a shadow on the validity of Menger's vision or the reality of consumer supremacy. The truth remains that, at any given time, the market is effectively deploying the best current information commanded by market participants and the most accurate and shrewdest entrepreneurial judgments concerning future market conditions. What drives and motivates such deployment is the incentive to win pure profit, through improving the faithfulness with which consumer preferences are respected in the patterns of production.

Thus, when Mises declares any intervention by government that might alter market prices (or other decisions that might have been made in an unhampered market) to be harmful, he does not imply that the prices (or other decisions) that would have emerged in an unhampered market on any given date are optimal in the sense that they accurately reflect all the considerations an omniscient observer would wish to have taken into account. What he means is that the existing conditions in an unhampered market express the most strenuous efforts on the part of the shrewdest entrepreneurial minds to

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identify and correct existing discrepancies between what *might* be done to best satisfy consumer preferences and what *is* being done. Not only are these strenuous efforts being made at all times, these efforts have been made in the past and current market prices have been modified (from those of the past) to the extent that the *past* shrewd judgments of entrepreneurs revealed those earlier plans to have been "false."

When Mises emphasizes the virtues of real-world market prices and transactions, which continually generate his "plain states of rest," he was not simply emphasizing the obvious notion that voluntary exchange leads to mutual gain. Rather, he was emphasizing the role played by real-world prices and transactions in the exercise of consumer sovereignty. For Mises, the supremacy of the consumer is not simply a tendency manifested in the ongoing entrepreneurial-competitive market process; it is a reality fulfilled at every moment. Certainly such supremacy is not to be confused with any hypothetically "perfect" allocation of resources to correspond to the pattern of consumer preferences. Where neoclassical welfare economics focused exclusively on such possible correspondence, Mises' more "dynamic," "process-oriented" mindset focused on a quite different aspect of markets. In seeing the market as *continually striving*, as it were, to better satisfy consumer preferences, Mises articulated an understanding and appreciation of free markets that, most unfortunately, relatively few of his readers have themselves understood and appreciated.

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Mises and the Dialog of Science

Gordon Tullock

My first encounter with Ludwig von Mises was at a time when he was practically unknown to the American economics profession. There was a small but distinguished group of economists who admired and understood Mises, but most economists had not read any of his work. Unfortunately, he attracted a number of mainly younger economists who almost formed a church in his honor. They tended to misunderstand his main message and greatly exaggerated those minor parts of his work that were wrong.

Mises like most economists did make mistakes. Even where his work was fully up to the standards of his day, like his contemporaries, to some extent he has become obsolete. All these things may be said about any economist. Mises much more than made up for these flaws by his great positive contribution. Unfortunately, most economists never even knew of those contributions because they did not read him. Thus, the bulk of the profession remained in ignorance of his great positive contribution. Economics was much handicapped as a result. The existence of a small group of eccentric students who practically deified him made the situation even worse. The only bright spot was the existence of a collection of very good economists, of whom Israel Kirzner was a leader, who understood his work and not only taught it but made significant improvements.

Economics tends to have warring schools. In the long run we hope the best will triumph. The current revival of Mises is an example, but not necessarily the final word. Even today only a minority of economists have read his work. Still the situation is much better that it was. Once again, Kirzner has played a major role in this revival, and his paper is a further step in the process of spreading the Mises message.

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Contesting the Dominant Opinion

The problem to which Kirzner mainly directs his attention is more than verbal but nevertheless has verbal aspects. Mises, like many economists of his day (including me), used language that implied the system was more accurate than it actually was. Speaking from my own memory, economics came close to a real war between interventionists of various sorts and advocates of the market economy.

I can recall a fellow student who thought that a planned economy would double our national product. He was an intelligent man and more or less reflected what, if not the dominant opinion, was certainly one strongly held. Many others, of course, thought various specific reforms were necessary. No doubt improvements were possible but most of the suggested reforms would have made the situation worse.

Under the circumstances there was a tendency to accept things as they were as a defense against this kind of more or less dominant opinion. Mises, of course, was particularly strong in his position on the planned economy. He had after all produced the first strong disproof of its feasibility. That his language was somewhat unformed is not surprising. In particular, the specific faults emphasized by Kirzner no doubt looked insignificant in view of the major problems of convincing people that the market works.

The Market Process School

Once again, according to my memory, I did the same thing, although of course I was a very minor student at the time. Not only I but many important economists of the day said the same sort of thing. It has been one of the major contributions of the market process school and Kirzner in particular to indicate that equilibrium either does not exist or is imperfect. What is important is a social structure in which people are continuously pressed to improve. Kirzner mainly talks of entrepreneurs continuously seeking new profit opportunities. The same phenomenon is found, however, when a housewife decides to look in one more shop before finalizing her purchases. All of us, and for that matter many nonhuman species, seek improved outcomes (see Tullock 1971). No doubt the entrepreneur is more important, but the phenomenon is widespread.

Of course, that is not all that market process is. It involves a significant improvement in the field. Mises, like many other economists of his day (including me), tended to take what from the present day appears to be too static a view of the economic system. The view that it was always in equilibrium is, of course, true only with a very special definition of equilibrium. If we define equilibrium as the current

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situation, then we are always in equilibrium. A definition rather like this has been used occasionally by members of the Chicago school. They will point out that any situation that is not changed is not changed because the change would be too expensive.

As an illustration of this type of meaning for equilibrium, during the recent San Diego meeting of the Western Economic Association, I saw a dime on the floor and picked it up. A friend, a good Chicagoan, laughingly said that it must have been an optical illusion. In essence, he was saying that the coin on the floor was a nonequilibrium phenomenon. An Austrian might not have even seen this as an opportunity for minor humor. My picking it up was an example of a corrective process although not necessarily a market process.

The genius of the market system is that people are motivated to seek out changes that will benefit society. But while they are seeking them the existing situation is a very short-run equilibrium. Between the time that Henry Ford decided he could make cars cheaper with the assembly line and the time that the new cheap cars came out, there was a period in which no change would be made simply because it took time. In one sense that was in equilibrium. Normally, however, that is not what we mean. Further, the fact we do not mean that causes no confusion.

Much of Kirzner's article is devoted to this particular problem and pointing out that Mises use of equilibrium does not confuse. Mises did not directly correct the static model, but the best argument for capitalism has been an argument for a process and the argument that the market process is the best process. This argument is to a considerable extent the work of Kirzner. In this article he deals with the apparent contradiction between Mises' use of equilibrium and market process procedure. No doubt verbally there is a difference, but I doubt that many were positively misled by it. It is worthwhile clearing up possible confusion like this and clearly pointing to the process and not to the potential goal. Nevertheless, Mises made a great contribution here even if his language followed the custom of his day and hence was a little imprecise.

Conclusion

We all make mistakes. Correcting them is part of the dialog of science. Mises pushed economics a great distance ahead. Kirzner in this article has pushed it even further. Let us all try to implement the scientific process and make still further gains.

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Industrial Organization and *Human Action*

Kenneth G. Elzinga

The year 1999 marks the 50th anniversary of the publication of the first edition of *Human Action*, the treatise on economics by Ludwig von Mises (1881–1973).[1] This book has been called "the essential foundation for the . . . academic movement of Austrian School economists, for which it continues to serve as the primary text today" (Herbener and Hoppe 1998: xix). For half a century, *Human Action* has been the English language magnum opus of Mises, one of the most eminent of the Austrian school economists.[2]

Human Action has a tripartite thesis: the book presents a case for thinking about human behavior from an economic perspective; it presents a case for market processes as the orchestrator of economic activity; and it presents a case for an Austrian view of money and credit.

Given the longevity and prominence accorded *Human Action*, we should examine what influence Mises' capstone book has had, if any, upon the field of Industrial Organization—one of the dismal science's specialties whose boundaries were only recently formalized, not long after the publication of *Human Action*.[3]

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[1]The Ludwig von Mises Institute has published a Scholar's Edition of *Human Action* and it is this edition of *Human Action* that is cited in the present paper.

[2]For an overview of Austrian economics, see Harper et al. (1971), a two-volume collection of essays honoring the 90th birthday of Mises. See also Dolan (1976) and Boettke (1994).

[3]Edward Mason's *Economic Concentration and the Monopoly Problem* was published by Harvard University Press in 1957. In 1958, the American Economic Association commissioned *Readings in Industrial Organization and Public Policy*, edited by Richard Heflebower and George Stocking. In 1959, Joe Bain authored the first prominent textbook with the title *Industrial Organization*. A field that was relatively new in the 1950s was established in most departments of economics by the 1960s.

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Human Action's Influence on the Field of Industrial Organization

There is more than one way to assess the influence of one scholar upon a field of study. The impact can be marked by the publication of a particular book that, at least for a season, sets a standard or benchmark for a field of study. Joe Bain's textbook would be an example in the field of Industrial Organization. In other cases, the influence is evident by the sheer number of important publications a scholar has in that field. F.M. Scherer would be seen as influential in Industrial Organization for this reason.[4]

In a very few instances, a scholar's influence upon a field of economics is made through that scholar's students. In Industrial Organization, Aaron Director would be the most famous example.[5] And, on occasion, a scholar's influence is so profound and lasting that later readers might be unaware of the influence because it goes beyond specific acknowledgment.[6] By any of these standards, Mises and his magnum opus *Human Action* have not been influential in the field of Industrial Organization.

The major textbooks in a field of economics are designed to represent and reflect the received wisdom and scholarship in that field. If *Human Action* has affected the field of Industrial Organization, one should find direct or indirect evidence of this in the leading texts.

Jean Tirole's *The Theory of Industrial Organization* represents a mainstream textbook in graduate Industrial Organization education. The *Handbook of Industrial Organization*, edited by Richard Schmalensee and Robert Willig, represents a contemporary survey of the field.[7] If *Human Action* has influenced the field of Industrial Organization directly, the evidence should be in these two sources.

Tirole's book contains no reference to Mises or to *Human Action*. Nor is Tirole's text peculiar in this regard. Furthermore, not a single

[4]Scherer was recently recognized by the Industrial Organization Society as its first Distinguished Fellow. The first edition of his textbook, *Industrial Market Structure and Economic Performance* (1970), marked a paradigm shift in the field from Bain's text, because of its greater use of theory as well as its extensive coverage of the literature in Industrial Organization, much of it subsequent to the Bain book.

[5]While Director himself wrote little, his impact upon the study of Industrial Organization, particularly in the field of antitrust, was enormous through the research he encouraged his students to pursue.

[6]An economics student today might be forgiven for not knowing specifically that Alfred Marshall was the inventor of the concept of elasticity because it is now received doctrine in the field.

[7]Published in 1989, the Handbook consists of 26 commissioned articles on specific topic areas in Industrial Organization.

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essay in the *Handbook of Industrial Organization* makes mention of *Human Action* in particular or Mises in general.

Lest the work of Tirole and Schmalensee/Willig be thought to reflect an MIT-Princeton tilt, and not represent Industrial Organization fairly, there is similarly no evidence that *Human Action* plays any role in the study of Industrial Organization at the University of Chicago. In *The Organization of Industry*, a compilation of George J. Stigler's seminal articles in the field of Industrial Organization, no reference is made to either *Human Action* or any other writing of Mises.[8] In the Industrial Organization course at the University of Chicago taught by Sam Peltzman, no entry to Mises appears on the reading list or course outline. Mises also is absent from the reading list and course outline of Lester Telser's course at the University of Chicago on Theories of Competition (see Tower 1990).

Ten other books about Industrial Organization contain no reference to Mises or *Human Action*.[9] An examination of 20 reading lists in Industrial Organization and Regulation assembled by Edward Tower (1990) also suggests that graduate students in the field of Industrial Organization who *are* reading *Human Action* are not doing so because the volume has been assigned.

The place of Mises in the field of Industrial Organization in the works just cited does not reflect a sudden or recent fall from favor. Mises' absence has been continual. For example, in 1958, under the editorship of Richard Heflebower and George Stocking, the American Economic Association gave its imprimatur to a survey volume entitled *Readings in Industrial Organization and Public Policy*. No publication of Mises was included in the volume, nor does any publication of Mises receive mention. Earlier, in 1952, under the editorship of Kenneth Boulding and Stigler, the American Economic Association commissioned a survey on price theory. The volume contains articles that, in the judgment of the editors, comprised the key contributions to price theory at the time as well as a list of articles the editors selected for additional reading. *Human Action* is not mentioned, nor is any other work by Mises.[10]

To put the matter starkly, Mises is not and never has been a line item on reading lists that prepare graduate students in the field of Industrial Organization.

[8]George J. Stigler is the Nobel Laureate in economics whom Industrial Organization clearly can claim as its own.

[9]The authors are: Bain (1968), Carlton and Perloff (1990), Greer (1980), Martin (1988), Scherer and Ross (1990), Shepherd (1997), Shughart (1997), Shy (1995), Waldman and Jensen (1998), and Viscusi, Vernon, and Harrington (1995).

[10]One paper by Hayek is mentioned in the section on German articles.

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These findings did not surprise me, for reasons I shall explain shortly. But they raise the question of why Mises' work has been ignored. To raise this question is also to ask two others. First, are there topics pursued by Industrial Organization economists that are simply beyond the scope and coverage of the study of economics as embraced in *Human Action*? In other words, was there something lacking in Mises' work, some topic or topics he neglected to address? Perhaps more important is the question of whether the field of Industrial Organization has paid a price by its neglect of Mises' *Human Action*? And if so, in what ways?

The Field of Industrial Organization and the Contents of *Human Action*

Human Action is a book of vast coverage. Between its covers lie almost 900 pages of dense text on microeconomics, macroeconomics, and the methodology of economic analysis. Because *Human Action* is an apologetic for a particular view of economics, the book has snippets of history, philosophy, sociology, psychology, and political science, which Mises uses as counterpoints to his own theory of human behavior. Notwithstanding the book's length, *Human Action*'s themes are too broad to address fully the detailed interests of any specialty field in economics, including Industrial Organization.

For example, the firm and the market are the "meat and potatoes" topics of Industrial Organization economics. The Schmalensee and Willig Handbook begins with the "Determinants of Firm and Market Organization."[11] Technological determination of firm size, transaction costs and the scope of the firm, and the rationale for vertical integration are discussed in detail. *Human Action* does not examine these topics in any detail.

Part 2 of the Schmalensee and Willig Handbook is "Analysis of Market Behavior," which contains separate papers on noncooperative game theory, theories of oligopoly behavior, cartels and mergers, mobility barriers, predation, price discrimination, vertical arrangements, product differentiation, imperfect information, and the timing of innovation. Here again, there is a wealth of detail about firm and market behavior that is not examined in *Human Action*.

One might conclude that the field of Industrial Organization goes after more topics than are covered in *Human Action*, and delves into them more deeply. But the disconnection between Mises and the field of Industrial Organization is not simply a matter of *Human*

[11]"The Theory of the Firm" is the introductory section in Tirole's textbook.

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Action's being broad and Industrial Organization's being deep. There is another element to the gap, and that is empirical.

Human Action is a book almost devoid of statistical data (there is not a table or even a graph). Industrial Organization, however, is a field that, until recently, has been primarily descriptive, and much of that description is quantitative. Edward Mason's graduate students at Harvard marked their entrance to the field of Industrial Organization by doing a doctoral dissertation on the structure-conduct-performance of particular industries. Such studies involved the measurement of firm and industry size across several vectors. Descriptive statistics on merger activity, the extent and trends of industry concentration, and the correlation between profits and market structure were (and still are) important topics of research.

Mises' work is disconnected from this kind of statistical analysis. *Human Action* purports to be a comprehensive treatment of economics. But many of the basic topics Industrial Organization economists have pursued would be off the radar screen of *Human Action*, in part because of the author's aversion to economic measurement.

The anti-empiricism in Mises is cryptic. Mises clearly sees a role for what he calls "economic history" and he recognizes that one can learn lessons from history. He writes: "The information that a certain firm sold at a definite date a definite type of shoes for six dollars a pair relates a fact of economic history. A study of the behavior of shoe prices from 1923 to 1939 is conjectural, however sophisticated the methods applied may be" (Mises 1998a: 328).

Now what is to be made of this sentence? Surely knowing that Mrs. Jones bought a pair of size 5 pumps on June 6, 1925, is not by itself economic history. And just as surely there are effective methods of estimating shoe prices over time. Such procedures are bedeviled by problems of sampling, weighting, and quality changes, but it is misguided to claim that economists with an interest in time-series data on shoe prices should avoid the topic altogether, as if any finding would be mere conjecture.

Nonetheless, Mises distrusts attempts to measure current prices, costs, and profits. This trait puts him outside the field of Industrial Organization, since most articles in the field involve quantitative analysis. Schmalensee and Willig devote much of their *Handbook on Industrial Organization* to empirical methods and results. There is no counterpart to this in *Human Action*. No student could use *Human Action* as a foundation for doing a real-world industry study.

One questions whether the aversion by Mises to empirical work, such as measuring industry prices and output, is based only on estimation problems, of which economists are generally aware. Mises' hostil-

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ity goes deeper and may be related to the prospect that such numbers can play into the hands of central planners and rent-seeking coalitions. Perhaps Mises feared not the error terms common to economic statistics but the uses to which such data might be put by the state. The parallel that comes to mind is how careful census rolls maintained by the Dutch were used by the Nazis to seek out Jews when Germany conquered the Netherlands in World War II.

There is, of course, considerable work done by Industrial Organization economists that eschews empirical research. Tirole's text reflects the contemporary tilt toward theory over empirical work; the *RAND Journal of Economics* is the premier outlet for theoretical work in the field. Yet even these Industrial Organization theorists do not draw on Mises' work.[12]

The game theory literature in Industrial Organization shows no imprint from Mises. In like fashion, no student could use *Human Action* as a foundation for understanding Nash-Bertrand-Cournot models. Indeed the mathematical formulation used in the game theoretic literature to understand competition among the few would represent one more example of the mathematization of economics that Mises disliked and disavowed (see Mises' stark language at p. 347).

Human Action and the Monopoly Problem

The field of Industrial Organization extends from administered pricing to zero-sum games. But its heart and soul has been the problem of monopoly. The point of greatest overlap between *Human Action* and Industrial Organization specialists is in *Human Action*'s chapter 16, "Prices," with its section 6, "Monopoly Prices."[13] Mises writes: "There is in the operation of a market economy only one instance in which the proprietary class is not completely subject to the supremacy of the consumers. Monopoly prices are an infringement of the sway of the consumers" (p. 272). Walter Adams or Willard Mueller could have written those words. But Mises' analysis of the monopoly problem is outside the mainstream of Industrial Organization (though not as close to the stream's banks as it once would have been).

Mises sees monopoly prices as emerging only when one firm controls the "whole supply of the monopolized commodity" (or "a group of

[12]I know of no citation to *Human Action* found in any article published in the *RAND Journal of Economics* (formally the *Bell Journal of Economics*).

[13]For a more complete reading of Mises on monopoly, see his "Monopoly Prices" (Mises 1998b). This previously unpublished paper, published now in *The Quarterly Journal of Austrian Economics*, was written by Mises in July 1944 and goes into more detail than the material Mises put in *Human Action*.

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sellers acting in concert") (p. 355). But to Mises, controlling the whole supply means that if there are fringe firms (or firms producing close substitutes) that have a positive supply elasticity, the putative monopolist (or cartel) will have its control over price thwarted. Mises, therefore, concludes that "duopoly and oligopoly are not special varieties of monopoly prices" (p. 359) because, *sans* collusion, there will be rivalry between them.[14]

Mises dismisses price discrimination as a policy concern. He writes "that within a market economy not sabotaged by government interference the conditions required for price discrimination are so rare that it can fairly be called an exceptional phenomenon" (p. 388). *Human Action* does not anticipate or incorporate the profound insight that a great deal of actual price *competition* in oligopolistic markets takes place through price changes that, viewed statically, are discriminatory as between the customers of a given seller.

The central reason Mises would dismiss the case for an activist government agenda against monopolies and cartels is the prospect of new entry. Here his reasoning is now conventional wisdom in Industrial Organization. "In the long run . . . a national cartel cannot preserve its monopolistic position if entrance into its branch of production is free to newcomers" (p. 360).[15] Without ever saying so explicitly, Mises' conviction is that, absent government protection, monopolies and cartels cannot survive in the long run. Without ever saying so explicitly, Mises believes that antitrust enforcement in the short run would entail more costs than benefits.

The obvious query about all this is: What is the evidence for eschewing antitrust enforcement, or believing that entry barriers are low or that strategic behavior by oligopolists cannot maintain positions of monopoly power? For Mises and the "logical economist," there is no quantitative evidence necessary to draw the conclusions found in *Human Action*. Mises writes: "The mathematical description of various states of equilibrium is mere play" (p. 353).

[14]In language that remains cryptic to me, Mises adds: "One may wonder whether duopoly and oligopoly are of practical significance" (p. 360). Are there many questions that trump this one in antitrust economics? After raising the question, he asserts: "As a rule the parties concerned will come to at least a tacit understanding concerning their quotas of the reduced sales" (p. 360). But he never advocates antitrust enforcement against noncooperative oligopoly strategies.

[15]"The great monopoly problem mankind has to face today is not an outgrowth of the operation of the market economy. It is a product of the purposive action on the part of governments" (p. 363). "If monopoly prices prevail in the sale of the product of big-size business, the reasons are either patents or monopoly in the ownership of mines or other sources of raw material or cartels based on tariffs" (p. 368).

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But such a gloss may not satisfy those who wonder: Are consumers gouged in markets with high concentration? Are such markets impossible to enter? Do such markets generate sustained high levels of profits? These are basic questions in Industrial Organization. And for some time, the conventional wisdom was affirmative on all three questions.

Today, the conventional wisdom is quite different. It lies closer to the Mises position, but the teachings of *Human Action* contributed little if anything to the profound perspective shift. The shift came through empirical work. A number of economists generally but not exclusively associated with the Chicago School of economics cast doubt on the conventional wisdom regarding concentrated markets. The work of what Mises calls the "logical economist" was not a player in this, one of the most central debates in Industrial Organization. It took the work of Harold Demsetz and Yale Brozen, to cite two central players, to gain the profession's attention.[16] And this attention was captured in large part through their working with the same kind of empirical data and statistical analysis that first led to the concentration-really-counts hypothesis.

Human Action's Value Added to Industrial Organization

Human Action's rational actor model is uncongenial to other academic disciplines. But not to the applied price theorist tilling the Industrial Organization vineyard. Economists within the ranks of Industrial Organization already generally are persuaded of the usefulness of thinking of human behavior as responsive to a cost-benefit calculus.

Much of *Human Action* is taken up with a discussion of monetary policy, the business cycle, and the shortcomings of Keynesian economics. Here again *Human Action* would have a sympathetic or at least indifferent audience among Industrial Organization economists. Most Industrial Organization economists echo the prayer of George Stigler, who claimed that every day he thanked the Lord that he was not a macro-economist.

Mises had an unflinching belief in what is paradoxical to so many noneconomists: that self-interested individual behavior generates a higher order of social cooperation than can be found in socialist or communistic states. Most Industrial Organization scholars also share a preference for market solutions over government solutions. The

[16]See, in particular, Demsetz's "Two Systems of Belief about Monopoly" in Goldschmid, Mann, and Weston (1974) and Brozen (1982, especially chaps 7, 8, and 10).

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primary policy debate among Industrial Organization economists involves tweaking the market system through such policy mechanisms as antitrust and public utility regulation.[17] Mises could restrain his enthusiasm for tweaking.

The question raised earlier was: Has Industrial Organization paid a price in its neglect of Mises? The answer is yes. What *Human Action* adds to Industrial Organization that the field has not fully appreciated can be summarized in three points.

Point 1: Mises cogently explains in *Human Action* that markets do not equilibrate and then stop. The behavior of markets, in the Austrian view, is always a journey and never a destination. If markets were sentences, they would have lots of commas, an occasional semicolon, and no periods. This is second nature to Austrian economists but not to most Industrial Organization economists working out of the neoclassical paradigm. Even when Industrial Organization economists borrow from the market landscape portrayed in *Human Action* (and in the writings of other Austrians), Mises (and the Austrians) go unrecognized (and unacknowledged).

For example, one of the finest case studies in Industrial Organization is *Folded, Spindled, and Mutilated: Economic Analysis and* U.S. v. IBM by Franklin M. Fisher, John J. McGowan, and Joen Greenwood (1983). This book is an economic analysis of the Sherman Act litigation brought by the U.S. Department of Justice against IBM in 1969. The volume adheres rather closely to the conventional Structure-Conduct-Performance chain of the Industrial Organization economist. But in describing the roiling technological changes in computer hardware, the authors report that "a focus on long-run equilibrium can be a major error in the analysis of a real industry" (p. 19). Mises would have approved.

Because of the absence of an equilibrium, the authors could not easily define the boundaries of a market and calculate market shares. Fisher-McGowan-Greenwood even refer episodically to the market as a process in their analysis of the IBM case (see pp. 19 and 38).[18]

[17]To be sure, the antitrust and regulatory issues about which Industrial Organization economists do research and offer policy advice often involve sizable quantities of resources and consequential decisions about their allocation. But relative to the explicit central direction of economic activity that Mises opposed, the stakes are modest.

[18]It was out of their work on the IBM case that Fisher and McGowan developed their critique of the use of accounting data to infer monopoly profits. Ever since their pathbreaking work on this subject, Industrial Organization economists have been much more cautious in the use of accounting data. That historic accounting records could tell nothing about monopoly pricing is another position that Mises had put forward (see, for example, pp. 343–47), though Fisher and McGowan explore the wedge between accounting data and economic variables in far more detail than is found in *Human Action*.

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But, as I mentioned in a review of the book, there is no reference or credit given to Austrian economics in the volume (Elzinga 1983).

Point 2: Along with others in the Austrian tradition, Mises underscores the importance of the entrepreneur. In doing so, he did not underscore the individual but rather a function: that of the economic agent "acting . . . in regard to the changes occurring in the data of the market." This is a function that can be carried out in a market economy by a supplier of capital, a supplier of labor, or a supplier of managerial skills (see especially pp. 253–55). It is the entrepreneur, Mises claims, who gives "direction of all economic affairs . . . in the market society." And yet, as he stresses, it is the consumer who is sovereign (p. 270).

Industrial Organization economists understand the comparative statics of market equilibrium and how profits and losses are the signals that attract or repel resources into or out of markets. But this lens into economic reality does not adequately focus on the entrepreneur who recognizes disequilibrium situations—or more importantly recognizes opportunities for gains from trade by *upsetting* an existing equilibrium situation. As Mises put it, "The entrepreneur is the agency that *prevents* [emphasis mine] the persistence of a state of production unsuitable to fill the most urgent wants of the consumer in the cheapest way" (p. 333). The entrepreneur is not satisfied with the harmony of markets smoothly and efficiently clearing, but instead the entrepreneur breaks through with new goods and services or new production techniques or new distribution channels that disrupt the status quo.

Point 3: Along with others not confined to the Austrian school, Mises shows the nexus between individual liberty in the economic sphere and individual liberty in the political sphere. Those who claim to be able to separate the two, Mises demonstrates, are guilty either of strategic dissembling or of ignorance.

Friedrich A. Hayek's *The Road to Serfdom* and Milton Friedman's *Capitalism and Freedom* are the two best-known books that argue the link between free enterprise and civil liberties. But if one were to commend a trilogy on the nexus between economic organization and individual liberty, *Human Action* (especially Part Five, *Social Cooperation without a Market,* and Part Six, *The Hampered Market Economy*) would be the third compelling literary composition on the theme. Industrial Organization economists rarely pull levers of political power. But Mises instructs those who do that an "economist can never be a favorite of autocrats and demagogues" (p. 67).

The Bluntness of *Human Action*

The most striking feature of *Human Action* is its directness and boldness. This is also the book's most maddening feature. Over and

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again, Mises makes a bold claim and I wonder: How does he know that to be true? Mises asserts: "No man is qualified to declare what would make another man happier or less discontented" (p. 19). Yet, my best friend, my accountant, my physician, my pastor, and my spouse all are in a position, on some matters, to declare what would make me "happier or less discontented." That does not make them dictators. It simply reflects specialized knowledge (or insight) about me that they possess.

Regarding advertising, Mises writes: "It is agreed among businessmen that it does not pay to advertise products other than good ones" (p. 318). Have telemarketers of vacation travel and investment scams been wasting their calls?

Mises declares that "No laboratory experiments can be performed with regard to human action" (p. 31). Can Mises prejudge the future contributions of Vernon Smith, Charles Plott, and Charles Holt?

Business schools do not get off lightly. Mises asserts: "These schools train the subalterns for routine jobs. They certainly do not train entrepreneurs. An entrepreneur cannot be trained. A man becomes an entrepreneur in seizing an opportunity and filling the gap. No special education is required for such a display of keen judgment, foresight, and energy" (p. 311).

Regarding demand and supply curves, Mises writes that such representations of economic reality "do not add a whit to our insight. Furthermore it is important to realize that we do not have any knowledge or experience concerning the shape of such curves" (p. 330). Statements like this about one of the most helpful tools in the economist's toolkit either cannot be taken literally or cannot be taken seriously.

The Debt of Gratitude to *Human Action*

And then, in the midst of such frustrations with Mises' assertions, I recall that because of economists like Mises, Industrial Organization economists (like myself) are able to examine micro issues involving beer industry mergers and predatory pricing in the market for less-than-truckload freight, secure in the knowledge that the academic milieu in which we work will not fall sway to grand illusions that the beer and trucking industries should be socialized. Industrial Organization economists can focus their attention on a narrow range of policy options because the policy options of government takeover or government control or government ownership of such industries are no longer on the table. It was not always so.

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Because of Mises and others, who were willing to take unpopular positions against socialism and communism, and to win the intellectual battle, Industrial Organization as a field of economics was able to unfold in an intellectual milieu congenial to private property and market exchange. So convincingly did Mises and his allies defeat the advocates of central planning that today it is difficult to find a self-proclaimed socialist or communist. Those sympathetic to central planning now promote their policies under different names.

In light of current concerns of creeping socialism, Mises' unambiguous proclamation of the social cooperation promoted by free markets is a lesson that requires continual relearning.

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Mises, Monopoly, and the Market Process

Frank M. Machovec

Kenneth Elzinga's paper is written in an easily digestible style, and its technical analysis is readily accessible to those who are not specialists in Industrial Organization (IO). Three of his points are especially noteworthy. First, he methodically demonstrates how one would assess, for any field, the impact of a particular scholar. His useful tripartite checklist includes a survey of the indexes of early texts in pure theory, a review of the contemporary reading lists of the graduate courses taught by leading IO professors, and a search for evidence of influence on the great teachers who shaped IO during its infancy, such as Aaron Director at the University of Chicago and Edward Mason at Harvard, whose doctoral students produced empirical dissertations that built the new field's data base and enhanced its models.

Second, Elzinga should be praised for his willingness to criticize Mises' attitude toward quantitative methods. Despite the insightful contributions of Mises in several areas, his position on the value of mathematical and statistical analysis has been counterproductive to Austrian scholarship. If an entire profession totally ignores an individual's work because it is devoid of empirical content, then no debate can be ignited. The great strides in undermining the old conventional wisdom on antitrust activism were accomplished by those who engaged the enemy with their own weapons. Moreover, the "new learning" in IO—which has fueled thinking about competition and monopoly in process terms among equilibrium practitioners—was initiated by empiricists who seem never to have read Mises and certainly would disagree with his unidimensional reliance on pure logic to build theory.

Jevons' approach would have been more fruitful. He coupled his endorsement of the application of equilibrium analysis (to the firm) with a warning that the use of mathematics does not "ensure the

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attainment of truth" (in Machovec 1995: 9). The profession's monogamous attachment to equilibrium thinking led to a pro-planning disposition that has not yet been fully nullified. Mises was correct, therefore, to pound home the point that "the main deficiency of mathematical economics" is its pedagogically misleading assumption of perfect knowledge, which enables it to abstract from the heart of the market process, namely, the equilibrating actions of entrepreneurs, who recognize "a discrepancy [in utility] between what is [being] done and what could be done," and who profit by redirecting these undervalued and hence misallocated resources (Mises 1996: 336, 355–56). Unfortunately, Mises also made numerous derisive comments about quantitative methods (as on pp. 350–57) that were not helpful in shaping the skills required to influence modern economic thought.

The third and most salient point raised by Elzinga is this: Although the writings of Mises have never been cited in the mainstream IO literature, his work provided a forceful and convincing antidote to socialism, an antidote that had spillover effects in IO. The case for liberty in *Human Action*, plus the ideas Mises inspired in Hayek, created an intellectual countermovement that challenged the interventionist urges engendered by the neoclassical equilibrium paradigm. However, we must not assume that Mises had condemned the general-equilibrium construct per se, for he did not. Mises explained that the idea of "an evenly rotating economy" was needed as a foil to fully understand the final path of a market process in which everyone's plans were consummated, with no further changes in the system's parameters, including agents' expectations (Mises 1996: 248, 256). Thus, as far as pure theory is concerned, there should be no inherent "tension between [the general-equilibrium model] and Austrian economics" (Yeager: 1999: 22).

Mises' criticism was directed at the "error and confusion" created by the equilibrium paradigm, particularly the distorted, entrepreneurless vision that had emerged—a pro-planning vision that had rationalized Joan Robinson's 1935 claim that the real-world economy's failure to maximize welfare (due to informational asymmetries) was correctable via centralized data collection and centralized resource direction: "An all-wise dictator, to whom every utility function was known, could increase the social benefit derived from given resources by revising the constitution of the set of commodities produced under perfectly laissez-faire conditions" (in Machovec: 1995: 77–78). "Because of Mises and others," writes Elzinga, "the policy options of . . . government control or government ownership . . . are no longer on the table. It was not always so."

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Mises Confronts Monopolistic Competition

Despite some hard-to-follow discussion (muddled by his refusal to employ the diagrams he eschewed), Mises accurately pierced the soft underbelly of the influential critique adopted by the new mainstream of the 1930s, 40s, and 50s, which had argued that the so-called excess capacity created by monopolistic (or imperfect) competition is inefficient and hence reduces consumer welfare. In a nutshell, the waste theorem was this: If less variety were available (presumably due to central planning), then a smaller number of larger-sized plants, each operating at full capacity under perfect competition, could achieve minimum average cost *and* release capital for other uses, thereby yielding more utility for consumers than the alternative, prevailing regime of monopolistic competition. Mises, in his previously unpublished 1944 writings on monopoly, some of whose points were *not* incorporated into *Human Action,* explained that the equilibrium school's prescription would not enlarge welfare:

> Standardization of products can go as far as the public is ready to buy the cheaper article rather than a more expensive article of another pattern. It was the buying public that forced the Ford plant to substitute cars with various paints for the uniform black painted standard type [that was favored by Henry Ford as a cost-saving measure because it minimized assembly time]. The doctrine of imperfect competition . . . is . . . mistaken in its assumption that the structure of the schedule of physical costs alone . . . should direct [production] in a perfect world [Mises 1998: 15].

The profession eventually moved away from its early embrace of Joan Robinson's charges of inefficiency. As Elzinga has noted, the IO perspective has now incorporated much of the Austrian process perspective, yet neither Mises nor any other Austrian scholar has been cited during the transition. It will be profitable, therefore, to clearly delineate Mises' objections to Robinson's broadening of the concept of monopoly.

For Mises, monopoly is not present every time a state of affairs develops in which price exceeds marginal cost, as in neoclassical theory. Rather, he said that, in nearly every case, a monopoly price can be sustained only when government protection enables a *producer* to restrict output *deliberately,* so as to create profit through a price that exceeds average cost (Mises 1996: 359, 379). For Mises, the power to *engineer* monopoly profit does not exist just because *consumers* purposefully restrict their purchases of a *particular* variant of a given good in order to employ their withheld income to buy other variants of the same good. Therefore, from a Misesian perspective, the phenomenon of product differentiation does not lead to the antisocial

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appearance of what Robinson had characterized as a "world of monopolies." For Robinson, but not for Chamberlin, the minimum average cost was optimal. Mises, of course, sided with Chamberlin's view, but, inexplicably, he failed to weave his novel 1944 reasoning into *Human Action:*

> The fact that an enterprise does not use the full capacity of its equipment, although it would reduce average cost of production per unit by doing so, is . . . not necessarily an outcome of a monopolistic policy. It does not render competition "imperfect." As long as there is a more profitable employment available for the capital required for the expansion of production, it is reasonable for the entrepreneur to abstain from such a further expansion. It is at the same time reasonable from the viewpoint of the consumer [Mises 1998: 14].

It must be mentioned that the unending debate over the role of advertising is highly germane to this topic; however, for brevity's sake, this paper will not detour to address it at length. Suffice it to say that, although some of Mises' comments on advertising were foolish, the contemporary advocate of Misesian philosophy would contend that advertising preys upon, but does not create, the generic dispositions (including the desire for invidious distinction) that drive consumer demand. Since advertising is overwhelmingly brand oriented, not product oriented, its *net* effect upon society's what-to-produce decision is practically nil. Moreover, advertising reduces real costs by cutting search time, a process insight appreciated by Chamberlin but not by Robinson and Sraffa, whose pre-Galbraithian vision of producer sovereignty led them to portray advertising as the devil's brew through which product differentiation and monopoly power are created. The appeal of the Sraffa-Robinson-Galbraith position has proved to be enduring because it provides a justification for state vetoes of dollar-vote referenda (Galbraith 1971: 63, 74–79; Ulmer 1973: 24–26; Machovec 1995: 130, 132, 218–19, 326, n. 18).

How did the heirs of Adam Smith become so hostile to the market process? Under the perfect-knowledge postulate of the Walrasian system, no one firm can "see" a better mousetrap unless all its competitors simultaneously have the same vision. Since no advantages can accrue to anyone, alterations in the what and how decisions had to be attributed to exogenous factors. This way of thinking forced neoclassical economists, including IO pioneer Edward Mason, to dichotomize the market into a black-and-white mixture of excess-profit, utility-reducing monopolists and zero-profit, utility-neutral competitors (Machovec 1995: 179–80, 196–98, 269–76). By disallowing informational asymmetries, the appearance of pure profit must

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signal antisocial behavior. In other words, the equilibrium paradigm precluded uncertainty, and, thereby, it eliminated "the driving force of the whole market system": the profit-making Darwinian search by entrepreneurs (via trial and error) for improved adaptations in product and method (Mises 1996: 248–49, 293–94; Machovec 1995: 103–4, 175, 191). Therefore, when seen through the eyes of mainstream theory, the market process yields an inferior configuration whose excess profits and inefficient shortfall in output are *correctable* via the known, optimal design (see Boulding and Samuelson, in Machovec 1995: 282). As John Commons sensed early on, "The theory of [perfect] competition developed by economists is not a natural tendency towards equilibrium of forces but is an ideal of public purpose adopted by the courts, to be attained by restraints on the natural struggle for existence" (in Machovec 1995: 203).

Knight had warned in 1942 that "some distinction . . . must be made between temporary profit [derived from successfully facing uncertainty] and permanent monopoly revenue" (in Machovec 1995: 181). But, within the mathematical structure adopted by neoclassical economics, no such distinction is possible. Mises conceded that the neoclassical graph of a firm facing declining marginal revenue is valuable because it allows us to "schematize the deliberations of the monopolists," yet he complained, like Knight, that it fails "to distinguish . . . monopoly gain . . . from entrepreneurial profit" (Mises 1996: 378). After the transformation of economics by the revolutionary victory of the equilibrium paradigm, IO analysis could proceed in no other way, for, as Frank Hahn and Thomas Kuhn have explained, new training tools change our cognition, after which we reinterpret the world (see the quotes from Hahn and Kuhn in Machovec: 1995: 8 and 276, plus the historical evidence on pp. 45–48, 98, 124–31, 298–99).

Mises and the Deadweight Triangle

Mises also rejected the neoclassical position on the magnitude of the presumed welfare losses to consumers from oligopoly (as reckoned at some specified point in time). The profession's original estimates were based on the erroneous assumption that production cuts by the leading firm (to boost price) would *not* be replaced by other producers. Mises argued in *Human Action* that, if the brands of the leading firm's competitors are perceived as relatively acceptable substitutes, then these competitors will boost their outputs at the static moment of analysis and thereby capitalize on the leader's attempt to earn monopoly profit. Nonetheless, said Mises, if the leading firm has a sufficiently

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large share of the market (like General Motors, perhaps, in the immediate postwar era), it could still create a monopoly price, but its height would be a function of the reactionary capabilities of its competitors (Mises 1996: 359–60, 362–63). The 1944 paper contained an even stronger and more succinct statement on this topic, a summary that was fully compatible with equilibrium analysis but that did not make its way into *Human Action:* "The question is always: Can an individual gain by restricting production? If someone else is free to increase output, an individual can increase his profits only by increasing output, not by restricting it" (Mises 1998: 6).

For an excellent real-world illustration of Mises' point, see the description of the managerial infighting during U.S. Steel's unprofitable 1904–09 curtailment of production (in Chandler 1990: 134–36). Another example occurred recently in a less visible sector of the American economy: its toy-train industry. The General Mills Corporation resurrected Lionel Trains from bankruptcy in the late 1960s, after which Lionel embarked on a strategy of producing limited numbers of high-quality locomotives and passenger cars of popular railroad names, creating premium prices throughout the 1970s. Lionel had seen itself as immunized from entry by other manufacturers because its customers (mainly collectors) were believed to be nostalgically tied to Lionel's trademark. This assumption proved to be erroneous—and costly. During the 1980s several new firms introduced high-quality electric trains that appealed to collectors and to operator-hobbyists, causing a price softening not only in the market for the new models of all producers, but also in the previously hot resale market of prized Lionel issues from the 1940s and 1950s, which had supposedly been blessed with very low cross-price elasticities of demand.

The Misesian perspective on the extent of consumer welfare losses from oligopoly (with reaction) was finally adopted wholesale in a 1975 article—that employed elasticity data and an effective diagram—in the *American Economic Review*, the profession's flagship journal (Worcester 1975: 1015–22). However, as in the several cases described by Elzinga, not one iota of credit was given to Mises.

Future Policy Implications

Two interrelated questions on IO and *Human Action* remain to be discussed, each of which raises perplexing issues that hopefully will stimulate a fruitful exchange of ideas.

1. Is Mises' sole-source contention for monopoly valid? Or may exceptional conditions evolve within a free market that could result in monopolized restrictions of output *not* instigated by

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state protection against competition? John Stuart Mill warned against "the fatal tendency of mankind to leave off thinking about a thing when it is no longer doubtful." Therefore, even when "the received opinion [*is*] true, a conflict with the opposite error is essential to a clear apprehension and deep feeling of its truth" (Mill [1859] 1987: 105, 108).

2. Has the profession's axiomatic favoring of the consumer over the producer, bolstered by Marshall's geometric surplus analysis, caused misleading conclusions to be drawn on the loss of consumer welfare traceable to markets that are not perfectly competitive? Two subquestions arise. First, what is the appropriate time window for evaluating the impact of a new arrangement of capital that, from a neoclassical viewpoint, is monopolistic? Second, if static analysis is prescribed, how is the consumer to be defined? In other words, should we adjust our analyses to reflect the impact of modern savings and investment institutions that have unwittingly enabled consumers (in a general sense) to become the recipients of producers' surpluses? When consumers are taken as an aggregated class, is the market-specific, equilibrium-calculated loss in consumer welfare shorn of its deleterious overtones? Should we therefore challenge, even within a static framework, the profession's heretofore unquestioned acceptance of its traditional interpretation of "consumer" welfare?

As a preliminary to my first question, we should note that, in his identification of the taproot of monopoly, Mises was fully in accord with the classical economists, including Smith, Senior, J.S. Mill, and McCulloch, who tied the monopoly power of a firm to the power of the state to enforce a curtailment of output by coercively repelling entry (see Rothbard 1962: 591–92; Machovec 1995: 11, 16–17, 112–13, 180–81). The onset of equilibrium thinking during the neoclassical era brought a new perspective that obliterated the difference between entrepreneurial profit—earned by fashioning a higher level of utility for consumers, as described by Smith, Malthus, Say, Mangolt, and others (recounted in Machovec 1995: 123–31, 180)—versus the pure, classical monopoly profit garnered by obtaining exclusive production rights through the political system (see, in particular, the public-choice views of Smith, in Machovec 1995: 17). In the latter situation, the artificial rearrangement of prices causes a movement along the endogenously unalterable production-possibilities frontier to a lower (nontangent) iso-utility curve of the social welfare function (due to a constriction of the monopolized good, as in the traditional equilibrium exposition). Whereas, in the former scenario (based on

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the process perspective, which transcends the Robbinsian constraint of allocating *known* means among *given* ends), the entire n-space surface of production possibilities is pushed outward by the entrepreneurial discovery of undervalued resources that have been reallocated to create additional opportunities for consumers.

Walter Block has criticized Mises' shorthand description of monopoly (the intentional restriction of production) as insufficiently robust. A producer may withhold output for totally benign motives, such as speculation, conservation, or the desire to enlarge leisure, all of which limit the supply curve and raise price, but none of which are anticompetitive (Block 1977: 271–79). Supply limitations incidental to speculation, conservation, or increased consumption of leisure are independently undertaken actions, consistent with a spontaneous state of natural liberty, and hence differ substantively from a consciously conspiratorial, state-abetted design to boost price by denying others the freedom to supplement supply. Hence Block advocates a single definition for condemning a price as monopolistic, namely, the price must be the result of output restrictions linked solely to "an exclusive government grant of trading privileges." But that argument, which is rooted squarely in the classical writers, was reasserted repeatedly and emphatically by Mises (1996: 358, 361–62), as well as Rothbard (1962: 591–92, 598–99). The basis of Block's critique of Mises, therefore, seems unfounded. It is abundantly clear in Mises that his restriction-of-output criterion is used to explain the simple mechanics of a higher price, the *maintenance* of which requires his governmental-assistance criterion (except for the cases of public utilities and geographically rare minerals). These two criteria are wedded together; to divorce them is to misrepresent the position set forth in *Human Action*.

Now we can turn to my first question: Can monopoly power appear and persist without a governmental contrivance? If the answer is yes, the complete absence of an antitrust arm would create a moral hazard harmful to consumers. Of course, an entry barrier erected by the state is certainly sufficient for monopoly, *but is it necessary?* Two possibilities come to mind, each admittedly a statistical-tail case; nonetheless, their potential existence prevents an unqualified endorsement of the zero-antitrust position of most Austrians.

First, what if the classical view is only *generally* valid? Suppose, for instance, that irregularities in demand (intermittent purchases from a single buyer, with a large dollar variance between purchases), together with the high cost of transporting heavy equipment, serve to limit, perennially, the number of highway-construction firms in any given region. Then it would be easy to boost the price by colluding to control the bidding on contracts. No exclusive construction rights

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would have to be granted by any state agency; the technologies of production and consumption may simply "conspire" to enable a *small* number of experienced, far-sighted firms to manipulate the price modestly in their favor, so as not to create an irresistible incentive to enter. Such bidrigging *has* occurred, yet there are no sunk costs or artificial barriers shielding this industry from hit-and-run interlopers; therefore, there may exist natural entry barriers whose peculiarities are not yet fully understood. Similar results have been found in timber auctions from federal forests (Baldwin et al. 1997: 670, 688). Since the current role of the state in road building and Western land ownership is not going to be radically altered, some form of antitrust policy must be on hand to punish collusion; otherwise, a serious moral hazard will be created in certain monopsony markets.

As a second possibility, recall Mises' analysis of oligopoly. Mises explained that *if* the leading firm's market share is sufficiently large, then it might be able to extract pure profit by reducing production, despite output expansions from its rivals. A combination of horizontal mergers and Depression-era bankruptcies, followed by a highly destructive world war that eliminates one's foreign competition for a decade or more, could create an unacceptably long short-run period during which Mises' large market-share situation could prevail—*without any tariffs or other state protection.* Furthermore, the disservice to consumers could be compounded by tacit collusion on output quotas, which Mises himself conceded was likely. An enabling scenario such as I have sketched out here would be historically freakish, but it is not inconceivable.

Finally, should the role of consumer welfare, as usually interpreted, remain sacrosanct? The past debates within the mainstream over the *size* of static losses in consumer welfare seem to have prevented a reconsideration of the *relevance* of the consumer's share of the deadweight triangle. In addition, one must challenge the use of an exclusively static framework, which totally disregards the long-term cost efficiencies to be reaped from a new pattern of specialization in capital and labor.

Block has noted that "the producer, too, engages in consumption." By rejecting the a priori preference given by public policy (and economic theory) to the consumer surplus over the producer surplus, Brock updated Rothbard's challenge to the traditional notion of the consumer (Block 1994: 41–44, 58–59).[1] I concede Block's point that

[1]Block's position is based on Rothbard's refusal to embrace the time-honored maxim of Stuart, Smith, McCulloch, Mill, and Mises, namely, that a market economy's raison d'être is to elevate the interests of consumers over the interests of producers (see Mises 1996: 357, plus the citations from classical texts in Machovec 1995: 124). The founders, of course, would have strongly objected to the employment of their pro-consumer argument to justify

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input purchases by firms are acts of consumption (driven entirely by signals from their customers), and I applaud his willingness to confront this definitional conundrum, especially since antitrust action is frequently justified with the so-called burden borne by consumers from equilibrium-defined monopoly. However, the issues I am raising are different from Block's. The problem I want to address has two distinct components: the snapshot-in-time approach to assessing the burden of monopoly soon after its establishment; and the melding of consumers' and producers' surpluses via transfers to pension funds of corporate earnings and stock appreciations, which have enabled the lion's share of the surpluses of producers to be consumed by those who do not usually come to mind when the sociopolitical burden-of-monopoly flag is waved.

The static loss in consumer surplus is measured after an initial rise in price, a rise that is later overwhelmed by new specialization driven by the chastised reorganization of industry, which gradually yet inexorably reduces cost *and* price. For example, during the robber-baron era that fueled the Sherman Antitrust Act, the price of steel rails from Camegie's mills fell about 50 percent between 1880 and 1900, during which time the net change in consumer prices overall was zero. And between 1893 and 1900, when consumer prices had risen nearly 7 percent, the price of a pack of cigarettes declined 25 percent (Chandler 1990: 134–36; Chandler 1977: 386.) Similarly, as a result of Rockefeller-type innovations in extraction, processing, and distribution, a broad spectrum of fuel and mineral prices have been falling for a century in real terms, despite occasional attempts to form cartels (Simon 1996: 28–36). Of course, the very best illustration of the cost and price reductions engendered by the market's "monopolistic" evolutionary process is the ongoing restructuring of the microelectronics industry, one of whose visionaries, Microsoft, was targeted with prosecutorial punishment (as were IBM in the 1960s and A&P in the late 1930s). Regrettably, the neoclassical prism through which mainstream theorists come to understand monopoly and competition fosters a rationale for destroying our economy's most talented and helpful offspring. We all want the cost-saving social benefits of the deepening specialization wrought by the imperfectly competitive market process, but the equilibrium-trained mind does not want to relinquish the emasculated behavior it expects from a perfect competitor.

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the seizure of producers' rents [as facetiously put forward in a reductio ad absurdum argument in Block (1994: 41)]. Adam Smith, for example, approvingly recognized the Schumpetarian "bait" that must exist to induce the entrepreneurial speculations that serve consumers (see, e.g., Smith in Machovec 1995: 90, 101–3, 105–7).

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A dynamic perspective is not driving the change-in-consumer-welfare analyses at the Justice Department; therefore, the definition of consumers—and of their *net* benefit/harm, direct and indirect, that has accumulated at any given point in time from neoclassical monopoly—rises to paramount importance. The classification problem is becoming increasingly relevant as more and more retirement accounts flow into equities, thereby making "consumers" (in the broader context) the ultimate beneficiaries of the "monopoly"-enlarged surpluses of producers. As Peter Drucker (1985: 191) has astutely observed, this trend has socialized America's capital without socialism (for the trend data, see Machovec 1995: 339–40, n. 3). The only way to circumvent the misleading policy implications of the static burden criterion is to define consumers narrowly as only those buyers in a given market who are also members of the Marxian proletariat (and who therefore never receive offsetting dividend payments from the profits or capital gains derived from the "burdens" suffered in all other markets).

Conclusion

This paper's purpose was threefold: First, to review and evaluate Elzinga's essay; second, to provide additional discussion of the Misesian critique of the mainstream's redefinition of monopoly and its subsequent charges of productive inefficiency and excessive welfare losses; and third, to pose controversial questions on two presumably settled issues: the source of monopoly power and the segregation of the surpluses of consumers and producers. Such exercises are necessary, said Mill, to test our fidelity to "received opinion." Sometimes the resultant "collision of opinions" leads us to amend our original convictions by revealing lacunae of truth that had been missed in previous analyses. However, even if the conventional wisdom "be not only true, but the whole truth," its future resilience requires that it be "vigorously and earnestly contested"; otherwise, "the doctrine . . . will be in danger of being lost or enfeebled, and deprived of its vital [salubrious] effect" (Mill 1987: 80, 115–16).

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Ludwig von Mises and the Case for Gold

George Selgin

Ludwig von Mises is well-known for his uncompromising defense of the gold standard during a period when that standard was being denounced by most other prominent economists. Mises' reasons for preferring gold over a managed fiat money are not so widely understood. Some self-styled "Misesians" defend the gold standard (or an extreme "100 percent" gold standard) on ideological and moral ("natural rights") grounds, while portraying it as a practically flawless institution (Rothbard 1974, Sennholz 1975). Mises, in contrast, made a utilitarian case for the gold standard, while recognizing gold's drawbacks: Mises defended the gold standard, not because he considered it ideal or because he thought fiat money immoral, but because he was convinced that a managed fiat money would prove less stable than gold.

I plan to explore in some detail Mises' views, as conveyed in *Human Action* as well as elsewhere, concerning an ideally behaved money stock and his reasons for seeing a gold standard as the nearest practical approximation to this ideal. I will show how Mises' argument involves a peculiar and unsatisfactory blend of consequentialism and strict a priori reasoning. His case for gold was based in large part upon his denial of the possibility of measuring, even approximately, changes in money's purchasing power. Mises' argument is unsatisfactory, both because it exaggerates the problems involved in attempts to deliberately stabilize the "inner objective exchange value" of a fiat money, and because, taken at face value, it undermines Mises' ability to draw any meaningful comparison between the historical performance of the gold standard and that of fiat money.

Nor was Mises able to make a convincing a priori case for the gold standard using what would now be labeled public-choice style arguments: Mises claims that disagreements concerning the direction

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and extent of changes in money's purchasing power must render a managed fiat money a plaything of politics. But Mises himself admits that this problem can be overcome by making deliberate changes to the growth rate of the money stock only in so far as these serve to avoid "obvious" changes in money's purchasing power—changes that reveal themselves in all credible price indexes. It is not clear that such a crudely managed fiat money would prove less stable than gold in practice, especially in light of Mises' acknowledgement of the failure of the classical gold standard to prevent "obvious" changes in money's purchasing power. That the most dramatic, historical fluctuations in the value of money—the kind that can be recognized without the aid of statistics—have involved fiat moneys is itself not conclusive proof of the superiority of gold, because (as Mises himself admits) most such episodes occurred during fiscal emergencies of a kind that would typically involve a suspension of gold payments. The relevant question, therefore, is whether a managed fiat standard can outperform a gold standard in "normal" times. And this question cannot be answered on a priori grounds or by appeals to *verstehen*.

I conclude my critique of Mises by suggesting that he might have made a more convincing case for gold by observing that fiat money is likely to be mismanaged, not only owing to the multiplicity of price-index targets, but also owing to constant pressure to target other economic variables, such as employment or interest rates. A regime aimed at stabilizing the value of fiat money is therefore likely to be short-lived. Although a gold standard administered by a central bank can also be abandoned "with the stroke of a pen," a gold standard based on a free-banking regime of the sort Mises favored, where individual banks of issue cannot renege on their promises with impunity, embodies a much more credible commitment to long-run price stability. Empirical evidence of the sort Mises disdained supports this argument, showing the tendency for inflation to persist under fiat money, but not under the classical gold standard, where private banks' promises to convert paper money into fixed quantities of gold were strictly enforced. Mises failed to make a convincing case for gold, both by refusing to make use of available statistical evidence and by failing to recognize the role of free banking in achieving a credible commitment to maintain gold payments.

The Ideal of a Money of Constant Inner Objective Exchange Value

Contrary to the impression conveyed by some of his followers, Mises did not defend the gold standard on ideological or moral grounds. His

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defense of gold was based on his belief that the merits of particular monetary policies and regimes should be assessed according to their influence upon money's purchasing power or "objective exchange value" (Mises 1980: 258). Like modern-day monetarists, Mises recognized the potentially distorting effects of changes in money's objective exchange value, including the tendency of such changes to alter the distribution of income and wealth "because individuals are apt to overlook the variability of the value of money" and "because variations in the value of money do not affect all economic goods and services uniformly and simultaneously" (p. 225). The displacement of relative prices following excessive or deficient growth of the money stock "falsifies accounts of profit and loss" and thereby distorts real economic activity (p. 235). Although steady appreciation or depreciation of money may be fully anticipated and allowed for in the drawing of long-term money contracts, a variable objective exchange value of money is bound to distort other terms of exchange (p. 225).

It was natural for Mises, in preparing the second (1924) German edition of his *Theory of Money and Credit*, to devote more attention to the destructive consequences of inflation than to those of deflation. Still, Mises—unlike some of his later followers (e.g., Rothbard)—does not by any means overlook the damage that deflation can do. Indeed, he recognizes at least one special social cost of deflation that does not arise in the case of inflation: under a gold standard, deflation becomes equivalent to a rising relative price of gold, which in turn means a greater diversion of resources to gold mining. Mises concludes from this that even a *steady* increase in money's objective exchange value would be undesirable under a gold standard.[1]

Although my summary of Mises' arguments thus far may make him appear to share the basic ideals of past and present advocates of price-level stabilization or zero inflation, a closer look at those arguments shows that he actually rejected the ideal of a money of constant purchasing power. Like Carl Menger and other 19th-century economists, and unlike modern proponents of zero inflation, Mises drew a distinction between changes in the exchange value of money originating on "the goods (or commodity) side" and ones originating "on the money side." Although Mises rejected the equation of exchange as a device inconsistent with methodological individualism, his argument is most readily grasped by reference to the terms of that equation: let $MV = Py$, with the variables defined as usual. Rearranging gives $1/P = y/MV$: the purchasing power of money depends on the quantity

[1]Milton Friedman's "optimum quantity of money" argument does not necessarily apply to a commodity standard (see White 1999: 110–11).

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of goods supplied as well as on the level of nominal income or spending. Changes in money's purchasing power that originate "on the goods side" are changes due to changes in y—the real supply of goods; changes in money's purchasing power that originate "on the money side" are changes due to changes in M or V—the supply of or (income-compensated) demand for nominal money balances.

While recognizing that the more popular ideal was that of a money "whose objective exchange value is not subject to any variation at all, *whether originating on the money side or on the commodity side*" (emphasis in original), Mises held "a money with an invariable exchange value, *so far as the monetary influences on its value are concerned*" (emphasis added) to be the ideal "of enlightened statesmen and economists" (Mises 1980: 268–69). Mises drew a distinction between the "outer" and the "inner" exchange value of money, where the former is simply money's purchasing power as conventionally understood, while the latter reflects "the money side" determinants of money's purchasing power only and is therefore a measure of nominal expenditures. Mises' ideal of a money with a constant inner objective exchange value (but with an *outer* exchange value that varied directly with changes in real output) was thus, in essence, equivalent to the modern idea of a nominal income (GDP) target. Mises himself, however (perhaps because of his refusal to employ the equation of exchange as a tool of reasoning), never recognized the equivalence of a stable inner objective exchange value of money and stable nominal income. This failure caused Mises to exaggerate the difficulties involved in efforts to deliberately achieve an "ideal" money and to overstate the relative advantages of a gold standard.

Managed Money: The Measurement Problem

Mises differed from proponents of zero inflation, not only because he rejected the treatment of a money of constant purchasing power as a theoretical ideal, but also because he denied that either the outer or the inner objective exchange value of money could be measured with any degree of precision. He therefore did not think the concept operational, in the sense of being capable of serving as a useful guide to a deliberate stabilization policy. Moreover, he believed that the managers of a (fiat) monetary standard would inevitably yield to political pressure, and especially pressure from advocates of inflationism (a policy aimed at deliberately reducing the inner objective exchange value of money), who would exploit the measurement problem by arguing for repeated revisions of the monetary policy target in a direction allowing for greater and greater monetary expansion. The

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practical result of this would be persistent depreciation of the (fiat) monetary unit.

In arguing against a policy of deliberate price-level stabilization, Mises recites the usual list of problems encountered in the construction of index numbers. These include the difficulty of allowing for changes in the quality and composition of available goods as well as the difficulty of assigning weights to prices of commodities in order to adjust for the commodities' varying degrees of prominence in consumer purchases (Mises 1990: 86–89; 1978: 87–89). Rather than merely concluding (as many other economists have) that such index-number problems prevent changes in the objective value of money from being observed with precision, Mises insists that they do not even allow us to say, except perhaps in extreme cases (when resort to index numbers would be otiose) whether the purchasing power of money is rising or falling. "The statements of the average man," Mises writes (1980: 177–78), "would almost form a better substantiation of the fact of a progressive fall in the objective exchange value of money than can be provided by all the contents of voluminous statistical publications." He concludes that, "Since it is impossible to measure fluctuations in the objective exchange value of money, even only approximately, we are not able to judge whether the increase of [the money stock] that has occurred during the last century [has] kept pace with the increase in the demand for money . . . or fallen behind it, or outstripped it" (p. 353). Because variations in the purchasing power of money cannot be measured with any degree of accuracy, efforts to adjust money growth in order to deliberately stabilize that purchasing power "run the risk of giving the wrong dose." Even if we could "roughly tell the direction in which we should work . . . we still have nothing to tell us how far we should go" (p. 257).

Mises assumes that the problems involved in attempts to measure and stabilize the purchasing power or *outer* objective exchange value of money are merely compounded by the need to distinguish between money's inner and its outer exchange value, so as to allow those "price movements which lie on the side of commodities" (Mises 1980: 218). Judged from a modern perspective, he seems to be mistaken: The norm of a stable inner objective exchange value of money is, as we have noted, equivalent to a stable nominal income norm. Although no unique and precise measure of nominal income exists, measures of nominal income are widely available and relatively closely correlated with one another, and the measurement of nominal income is at least not complicated by the sort of index-number problems involved in attempts to measure the outer exchange value of money. Mises' strictures against the employment of any price index as a monetary target

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do not nowadays constitute equally compelling arguments against attempts to implement deliberately Mises' own preferred monetary policy ideal. The lack of good *historical* nominal income statistics, from the early 20th century or earlier, does nevertheless make it necessary to rely upon early price indexes for judging the *historical* performance of alternative monetary arrangements. Moreoever, even today the lack of perfect correlation among various nominal income indices suggests that they are also imperfect indicators of movements in money's inner objective exchange value.

Mises favored a gold standard, not because he believed that it would succeed in entirely avoiding fluctuations in nominal income (or the "inner objective exchange value of money"), but because he believed that the fluctuations that were likely to afflict a gold standard would be of minor significance compared with those that would characterize a managed fiat money. In 1934 Mises observed that, although a gold standard

> introduces an incalculable factor into economic activity . . . it does not lay the prices of commodities open to violent and sudden changes from the monetary side. The biggest variations in the [inner objective exchange] value of money that we have experienced during the last century have originated not in the circumstances of gold production, but in the policies of governments and banks-of-issue [Mises 1980: 24].

The deflation of the 1930s itself was, according to Mises, not proof of the instability of gold but rather evidence of the damage caused by attempts to circumvent the gold standard:

> The thing for which the monetary system of our time is chiefly blamed, the fall in prices during the last five years, is not the fault of the gold standard, but the inevitable and ineluctable consequence of the expansion of credit, which was bound to lead eventually to a collapse [Mises 1980: 30].

By substituting gold-bullion and gold-exchange standards for 19th-century gold coin standards, central bankers were able, starting in the 1890s, to stretch available gold reserves, but only provided that creditor nations resisted the temptation to redeem their holdings of foreign exchange. In the late 1920s, the entire superstructure of inter–central bank credits so carefully erected during the preceding decades came tumbling down. It was "not the old classical gold standard, with effective gold circulation," that failed after 1929; what failed was "the gold 'economizing' system and the credit policy of the central banks of issue" (Mises: 1990: 85).

In Mises' opinion, the gold standard should be held responsible, not for changes in money's purchasing power that stem from politically

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inspired changes in the manner in which the gold standard is administered, but only for those changes in money's purchasing power that reflect "fluctuations in the conditions of production of the metal and variations in the industrial demand for it" (Mises 1990: 270). Although such fluctuations alone would render a gold standard imperfect, the variations in money's inner objective exchange value that could be attributed to them "are not immoderately great." Moreover, even if they were greater, a metallic base money "would still deserve preference over one subject to state intervention, since the latter sort of money would be subject to still greater fluctuations" (p. 270).

Tension in Mises' Arguments

A reader who has carefully followed Mises' arguments for gold up to this point may have noted a certain tension between them. On the one hand, gold is to be preferred to managed (fiat) money because of the lack of a reliable measure of money's purchasing power. On the other hand, gold is to be preferred to managed money because the gold standard is more stable in practice. Together these arguments beg the question: If the purchasing power of money cannot be measured with any degree of accuracy, how is it possible to conclude that the purchasing power of money is subject to greater variations under a managed monetary standard than under a gold standard? In *Human Action* Mises suggests that changes in the value of money, although they cannot be measured scientifically, are nevertheless capable of being assessed through the specific method of historical understanding (*verstehen*). It is hard to imagine, however, just how such understanding can be arrived at except by generalizing from observed movements in actual money prices (or nominal income). Statistical methods offer the best, albeit imperfect, means for making such generalizations in a more or less objective manner. In so far as they lack statistical support, Mises statements concerning the relative success of gold and fiat money in retaining a stable inner objective exchange value over time are hardly compelling. Mises, in other words, goes so far in attacking the very possibility of a scientifically managed money as to seemingly rule out the possibility of any scientific comparison of the historical performance of gold with that of irredeemable paper money.

Mises attempts to avoid self-contradiction by suggesting in places that very severe fluctuations in money's purchasing power can be recognized without statistical aids. In such cases "all people agree" that the value of money has moved in a particular direction (Mises 1966: 467). Price indexes, though they convey accurately enough the general direction of price movements during such episodes, are also

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unnecessary since they can only be trusted to the extent that they confirm that which is already obvious even to persons unfamiliar with official statistics. Mises' argument then reduces to the claim that the most extreme (and therefore most obvious) fluctuations in the purchasing power of money—like the German inflation of 1914 to 1923—have all involved fiat base moneys.

But this argument, too, seems far from adequate: Even though the most dramatic changes in money's purchasing power have involved fiat moneys, it does not follow that fiat money is generally inferior to gold. If the gold standard should not be blamed for changes in gold's purchasing power that were linked to politically motivated changes in the way the gold standard was administered (such as took place in the years surrounding the First World War), why should fiat money be considered inherently defective just because it, too, has occasionally been mismanaged? In principle, any monetary regime can be dismantled in response to some change in the state of the economy. Mises himself observed (1980: 435) how even relatively well-established gold standards had been abandoned "with the stroke of a pen" during wars. The question, then, is whether a gold standard regime is likely to be more robust to external shocks, and hence more "credible," than a fiat money regime. Mises, unfortunately, never supplies theoretical reasons for his implicit belief that a gold standard is likely to last longer than a fiat-based regime aimed at deliberately stabilizing money's inner objective exchange value. Moreover, as we have seen, Mises resists offering any statistical evidence of gold's superior staying power. On the contrary, in observing how historical gold standards were often dismantled during emergencies, Mises leaves his readers with the impression that a gold standard offers no greater guarantee against sudden monetary depreciation than a managed fiat standard.

Mises is, in fact, unable consistently to adhere to his own strictures concerning the impossibility of tracking changes in the objective exchange value of money. Thus, he cannot resist contrasting the relatively large fluctuations in money's purchasing power that have characterized various fiat money regimes with the "slow and comparatively slight movements in purchasing power" that characterized the gold standard (Mises 1966: 425). He also observes that the purchasing power of money rose during the decades prior to 1896, but declined thereafter until the outbreak of the Great Depression (Mises 1978: 69; 1990: 83). It is hard to see how Mises could have based these claims on anything other than summary price statistics, notwithstanding his belief that such statistics "are based on entirely false assumptions and display ignorance of the fundamental principles of both economics and history" (Mises 1966: 467).

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Ultimately Mises has no choice but to abandon his extreme position concerning the uselessness of index numbers. This allows him to suggest that gold has indeed performed better historically than irredeemable paper. It also serves to effectively undermine his claim that measurement problems alone must render a managed money standard impracticable: "The inadmissability of the methods proposed for measuring variations in the value of money does not obtrude itself too much if we only want to use them for solving practical problems of economic policy" (Mises 1980: 222; compare Mises 1966: 411).

Thus, Mises admits that measurement problems do not pose any insuperable barrier to a scientifically managed money. Although the ideal of a money of constant inner objective exchange value may be unachievable, there is no compelling reason to believe that measurement problems alone must render a managed paper money standard inferior to an (also imperfect) gold standard. The case for preferring gold to paper must rest on other than merely technical grounds.

A Public-Choice Case for Gold

Measurement problems are, in fact, only one of two potential drawbacks of managed money emphasized by Mises. The other, far more serious problem has to do with the tendency of a managed money to become subject to political pressures. According to Mises (1980: 258), once the principle is admitted that the state should deliberately attempt to influence the objective exchange value of money, "immediately the most violent and bitter controversy will break out as to how far this principle is to be carried." The reason is one that might have been given by a member of the modern public-choice school: While a stable inner objective exchange value of money might be most consistent with overall macroeconomic stability, changes in money's purchasing power involve costs and benefits that fall disproportionately on particular interest groups, some of which are more politically powerful than others. In a democratic, fiat-money-employing nation, interest-group pressures will then tend to pull monetary policy away from a stable (inner or outer) exchange value ideal. To these pressures one must add the bias of government authorities themselves, who may favor an inflationary policy owing to its ability to augment government revenues in a manner that circumvents the democratic process altogether (Mises 1980: 253–55). For all these reasons, schemes like Irving Fisher's compensated-dollar plan must ultimately prove "illusory and tantamount to open approval of the government's power to manipulate purchasing power according to the appetites of powerful pressure groups" (1966: 443).

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The fact that there is no one precise and universally accepted way to measure money's purchasing power, even if it alone does not constitute a fatal flaw of managed money, does play into the hands of those interest groups that would abuse such a money. Once "the credit policy of the central banks" became "dependent on the results of the index measurement, the various interest groups would immediately take sides on behalf of this or that method of calculation, according to whether they were interested in a rise or a fall of prices" (Mises 1990: 87). This suggests that, at the very least, a managed-money policy should limit itself to preventing only "those changes in purchasing power . . . which are admitted without question by all parties" (p. 93).

Although this part of Mises' argument for gold may appear to rest upon a normative judgment favoring a particular distribution of income and wealth, Mises is quick to observe that the problem is not the government's desire to placate particular interest groups, but its employment of an inefficient and ultimately self-defeating means—manipulation of the purchasing power of money—toward this end simply because this instrument allows government agents to avoid the costs of passing new legislation (Mises 1980: 262). Thus, inflationism is bad policy not because of the manner in which it redistributes wealth, but "because it is incapable of fully attaining its goal and because it leads to consequences that are not, or at least not always, part of its aim. . . . Its popularity, in fact, is rooted in the difficulty of fully understanding its consequences" (p. 262).

Mises objects to deflationism—a policy aimed at deliberately increasing the inner objective exchange value of money—for the same reason that he opposes inflationism. Deflationism is, however, unlikely to be the actual outcome of a move to managed money, because it tends to erode government revenues while favoring interest groups that have "not been particularly numerous or influential at any time in any country" (Mises 1980: 264). Because he thought deflationism unlikely, Mises devoted relatively little attention to deflation as a theoretical topic.

Do Mises' claims concerning the likely politicization of a fiat standard amount to a convincing argument in favor of gold? That a fiat standard introduces an inflationary bias in monetary affairs seems indisputable. But whether that bias renders a fiat money on the whole less desirable than a gold standard does not seem to be a question that can be settled on a priori grounds. Yet Mises, in both *The Theory of Money and Credit* and *Human Action*, suggests that a managed fiat standard is *bound* to be less stable than gold precisely *because* fiat money is managed deliberately: "The main objection raised against

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the gold standard is that it makes operative in the determination of prices a factor which no government can control—the vicissitudes of gold production" (Mises 1966: 473). But freedom from political control "is not a defect of the gold standard; it is its main excellence. . . . The gold standard removes the determination of cash-induced changes in purchasing power from the political arena [and thereby] checks large-scale inflationary ventures on the part of governments" (pp. 474–75).

A managed fiat standard, on the other hand, derives its popular support not from its ability to achieve in practice the first-best outcome of a money of stable inner objective exchange value, but from the fact that it alone is perceived as being capable *in principle* of fulfilling not only the aforementioned ideal, but also other, often conflicting, desires of various special interest groups.

In defending gold against the more politically popular alternative of a managed fiat money Mises implicitly employs something like a Rawlsian "veil of ignorance" argument. It makes sense to advocate fiat money if one belongs to a particular interest group that can benefit from inflationism or deflationism and if that interest group is part of a politically successful coalition. On the other hand, if one were forced to choose a monetary standard before knowing one's place in society, one would opt not for a potentially "perfect" fiat money, but for the more "accidental" consequences of a money "independent of deliberate human intervention" (Mises 1990: 90; 1980: 270).

It is from this point of view—the view from behind the veil of ignorance—that the pre-World War I gold standard can be said to have "functioned on the whole satisfactorily." Although that standard "did not secure the unattainable ideal of a money with an invariable [inner] objective exchange value . . . it did preserve the monetary system from the influence of governments and changing policies" (Mises 1966: 430).

The problem with Mises' argument is that it confuses the ignorance induced by donning a Rawlsian veil with ignorance *tout court*. In order to choose a gold standard over fiat money, the man behind the veil must know, not only that a fiat standard is likely to be deliberately manipulated in a manner that may be contrary to his self-interest, but also that the vicissitudes of gold, however unplanned, will not harm his interests even further. The argument for gold cannot, in other words, proceed on entirely a priori grounds, but must be empirically grounded—and this means in practice that it must be grounded at least in part in the sort of statistical evidence Mises disdains. It is not sufficient simply to list the shortcomings of fiat money and then declare gold the winner. The gold standard must be shown to be, first of all, a potentially credible arrangement and, second, an arrange-

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ment that, once in place, is relatively successful at stabilizing money's purchasing power.

The lack of any sufficient a priori grounds for preferring gold to a managed fiat money becomes especially evident if one allows, as Mises does at one point (1990: 94), that a fiat money might be managed so as to prevent only those changes in purchasing power that have "been ascertained over a considerable period with such unquestionable certainty that no one can dispute" them. In such a case, the purchasing power of money would be allowed to vary between upper and lower estimates that would move further apart as time passed. But more dramatic fluctuations in purchasing power would be resisted, because political pressure groups would not be able to justify them scientifically. Despite its evident crudeness, it is not clear why such a limited stabilization scheme would be worse than a gold standard. Indeed, there might be grounds for preferring it to the classical gold standard, since the latter did (according to Mises) allow even "obvious" purchasing-power movements to occur, like the deflationary movements of the last quarter of the 19th century.

Mises' public-choice argument against fiat money thus appears to be seriously undermined by his insistence upon the impossibility of assessing alternative monetary regimes according to their statistical performance. If price indexes are as unreliable as Mises claims, so that the only certain knowledge we have of changes in money's purchasing power is knowledge about those changes that are "admitted without question by all parties" and evident in *all* credible price indexes (Mises 1990: 93), then monetary management must limit itself to avoiding only such obvious price movements if money is not to become a plaything of politics. Evidently, the result would be a very crude form of managed money. Yet, crude as it might be, there would seem to be no grounds whatsoever for claiming that such a money would be worse than a pure gold standard. On the contrary, the gold standard, in its classical, gold-coin form, was "admitted by all parties" to have sponsored secular deflation—the kind of deflation that even a crudely managed fiat money might have avoided.

Making the Case for Gold

In insisting that a managed fiat money must become a plaything of politics, Mises hinted at the true advantage of a gold standard. A gold standard regime may in fact be more robust—less subject to sudden abandonment—than any rule-bound fiat regime. The reason for this, never articulated by Mises, has to do with the differing nature of enforcement mechanisms under gold and fiat regimes. Under the

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classical gold standard, paper bank notes embodied enforceable redemption contracts: their issuers were bound by the laws of contract to honor their promises to noteholders. Government monetary authorities that promise to stabilize the value of their fiat moneys operate under no similar contractual constraints: their "promises" are mere pledges, lacking the force of law. Because they incur costs that are low relative to the benefits they may derive from reneging on their promises, fiat-money–issuing institutions are more easily tempted to renounce their promises, that is, to disobey rules. Their immunity from prosecution by those holding their "liabilities" allows them to switch regimes with relative impunity, and this fact undermines the credibility of their commitments.

Although the classical gold standard only crudely approximated a rule for stabilizing money's inner objective exchange value, that standard had the advantage of being more strictly enforced and therefore more credible than later fiat regimes. Michael Bordo and Finn Kydland (1996) argue that the gold standard involved a credible commitment to return to a former parity following suspension, which served to lower expected and actual wartime inflation rates. Importantly, their claims are borne out by statistical evidence, which suggests that, although the classical (pre-1914) gold-standard era may have involved greater short-run price level variability than post-World War II arrangements, it also provided greater long-term price level stability, avoiding *persistent* inflation (Bordo 1993). In general, institutions that promised to obey the rules of the gold standard kept their promises. The lack of complete consistency of these promises with the goal of a stable inner objective exchange value of money was, to an important extent, compensated for by the fact that the promises were generally adhered to. Under fiat money, in contrast, a promise can be made that is more strictly in keeping with a stable inner objective exchange value of money; but this advantage is of little value because the promise is likely to be broken.

Commitments to uphold the classical gold standard were credible, not on account of any special attribute of gold itself, but because the institutions responsible for making the commitment were often private entities instead of being public or semipublic ones enjoying a kind of sovereign immunity from legal sanctions generally applicable to defaulting creditors. Under this interpretation, a completely free banking system, where no bank enjoys special government privileges or immunities, would be most likely to stick to its commitments. Thus, Mises' preference for free banking complements well his preference for a gold standard. Unfortunately, Mises himself, although he did emphasize the advantages of free banking in regulating the money

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stock, did not explain the bearing of limited state involvement in banking upon the credibility of a convertible monetary regime.

Conclusion

Although I find Mises' own arguments in defense of gold unsatisfactory, I have tried to suggest how an extension of those arguments could make for a more convincing defense of gold. This defense cannot, however, be sustained on purely theoretical grounds. Ultimately the merits of gold must be assessed in light of empirical (and statistical) evidence comparing the gold standard's performance with that of historical fiat standards.

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Ludwig von Mises and Price Indexes

Richard H. Timberlake

George Selgin's paper on Ludwig von Mises' monetary theory and Mises' advocacy of a gold standard is instructive and timely. Selgin emphasizes the "tension" between Mises' theory of money—particularly what Mises rejected in the way of a price level concept and price indexes—and his advocacy of a gold standard. Selgin concludes by showing that Mises' case for a gold standard is compatible with the favorable view he gave to free banking, and logically should have been married to it.

Treating Mises' writings critically and professionally has been difficult in the past.[1] His insistence on deductive reasoning as the exclusive means to truth not only violated scientific norms that routinely include inductive reasoning from empirical data, it also cut him off from many of his contemporaries in dealing with current issues. By contending that only individual preferences determine values, Mises carried the principle of subjectivism beyond its rational limit.

Perhaps Mises' attitude was defensible when his economic career was just starting because in that era data collections, time series, and statistical methods for dealing with them were crude and incomplete. Consequently, Mises may have felt justified in rejecting price indexes (inverted) as legitimate measures of money's value. He regarded money prices as an indispensable means for valuing economic goods and services. However, since he presumed that money prices—"objective exchange values"—were exclusively the result of subjective utilities, he could not accept an objective statistical construction of a general price level (Mises 1978: 62). A price index was an unacceptable means to "measure" an unmeasurable quantum.

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[1]Austrian economists too often and too uncharitably have bristled at any criticism that their mentor, Mises, could have been less than omniscient. For good reason, a creative scholar who errs is more believable than one whom his followers regard as inviolate.

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The Austrian Principle of Money

Selgin traces Mises' argument in deriving what might be labeled the Austrian Principle of Money: "Every variation in the quantity of money," Mises wrote, "introduces a dynamic factor into the static economic system." When the stock of money changes, even if money is gold, the circumstances of the situation inevitably result in relative price changes, and in wealth and income changes (Mises 1978: 62). Money to Mises was not neutral under any conditions, not even in thought experiments.

Mises' conclusions about price indexes and the Quantity Theory of Money are in sharp contrast to those of Irving Fisher, an earlier contemporary of Mises (14 years older). Fisher also recognized the impossibility of measuring subjective utilities. However, to Fisher the unmeasurability of utility was a good reason to use a price index as a guide to "corrections in the monetary standard," that is, the "compensated dollar." By this means the quantity of gold defining the gold dollar would be increased or decreased to keep a general price index from fluctuating unduly due to the vicissitudes of gold production (Fisher 1911: 22, 248–50). At the time Fisher made this proposal, world gold production was generating a mild gold inflation.

Fisher was acutely aware of the fact that without the concept of a price index, the distinction between relative prices and the value of money is almost opaque. "Individual [real] prices," Fisher (1911: 175) observed, "cannot be fully determined by supply and demand, money cost of production, etc., without surreptitiously introducing the price level itself."

Selgin notes Mises' refusal to use a price index at the same time that he (Mises) denounced statist inflationary policies and championed the gold standard. "It is hard to see," Selgin argues, "how Mises could have based these claims [concerning money's purchasing power] on anything other than summary price statistics."

Throughout his discussions of monetary policies and episodes of price level changes, one gets the impression that Mises is advising his readers not to do as he does—use an implicit price index to evaluate monetary phenomena—but to do as he says and avoid such devices. Apparently he felt that a price index in the hands of the unwashed would lead to the excessive political interventionism that he rightfully deplored. However, Selgin shows that the failure to admit the qualified use of a price index made Mises' plea for a gold standard unsound and unconvincing.

With the demise of metallic standards, all existing media became nominal—that is, fiat legal-tender moneys issued by central banks.

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Nevertheless, fiat or not, legal tender or not, paper notes or bank demand deposits, contemporary money is also real because it will buy real things. However, to cross the intellectual bridge from nominal fiat money, which is itself worthless, to the real things that a unit of fiat money will buy requires a statistical apparatus.

Price indexes are such devices. No index can ever be perfect, as Mises insisted and as all economists admit. However, it seems a vain subtlety to insist that a price index (inverted) is not an acceptable approximation of the value of money just because it is not "perfect." It says that the bridge from nominal to real money is impossible to build.[2] Yet, Mises and many Austrian economists, including the late Murray Rothbard, found that they had to use an implicit price index concept in order to write anything meaningful about the paper money inflations of the 20th century.

The Austrians' Misinterpretation of the Great Depression

Their unsympathetic view of price indexes is largely responsible for the Austrians' continuing and intransigent misinterpretation of the Great Contraction and Great Depression of the 1930s. Selgin cites Mises' passing remark that "*the fall in prices* [emphasis mine] during the last five years [1929–34] is not the fault of the gold standard, but the inevitable and ineluctable consequence of the expansion of credit [during the 1920s]."

Mises' principal disciple, the late Murray Rothbard, taking his cue from Mises, wrote extensively on this episode (see especially Rothbard 1963: 87). Rothbard argued that the Federal Reserve banks of the 1920s initiated an "inflation," even though the price indexes of the time fell slightly. He then extrapolated this "inflation," which he defined as "any increase in the stock of money not . . . covered by an increase in gold," into the argument that the stock of money in the 1920s was excessive (Rothbard 1963: 88). Had Rothbard used a price index to examine the monetary data of the 1920s, which because of his fealty to Mises he would not do, he would have realized that a mild deflation rather than an inflation marked the period. He then could have correctly interpreted the Federal Reserve System's subsequent deflationary policy for the disaster it was (see Timberlake 1999).

A Constitutional Gold Standard and Free Banking

Selgin claims that Mises' eloquent advocacy of free banking logically complemented his case for a gold standard. In arguing this position,

[2]Mises' "Regression Theorem," even though valid, does not serve this purpose.

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Selgin compares implicitly two different gold standards: (1) a Treasury or central-bank gold standard, in which most of the monetary gold is held in government vaults and serves as the basis for issues of government currency or "lawful money"; and (2) a more durable constitutional gold standard, under which private banks issue media of exchange redeemable in gold.

Under the first type of gold standard, fiscal "emergencies," worldly "shocks," and unforeseen "crises" inspire the governmental "authority" to renege capriciously on its promise to redeem its paper money with gold. Supreme Courts then legitimize the Treasury or central bank default (see Timberlake 1991). Without the authority to make their media legal tender and with the courts ready to enforce the banks' contractual obligations, private issuers of money would force each other to limit their issues prudently. Their gold reserves would be out in the open and constantly in use, moving between banks and the nonbank public in fulfillment of the banks' avowed commitments.

The complementarity of a gold standard and free banking, therefore, depends on which type of gold standard one is featuring. Even at best the Treasury or central-bank gold standards of the late 19th and early 20th centuries were all too vulnerable to governmental repudiation. Selgin's constitutional gold standard with free banking would be much more resilient.

Though Mises did not explicitly link free banking to a gold standard, he devoted five full pages of *Human Action* to a thorough analysis of the institution. "Free banking," Mises claimed, "is the only method available for the prevention of the dangers inherent in credit expansion. . . . Only free banking would have rendered the market economy secure against crises and depressions. . . . [T]he blunders committed by liberalism in handling the problems of banking were a deadly blow to the market economy. There was no reason whatever to abandon the principle of free enterprise in the field of banking" (Mises 1966: 443).

Free enterprise banks, Mises argued, could not overissue either banknotes or deposits. Any amount of overissue would find banknote holders, particularly other banks, returning the notes to the issuing banks for redemption in the promised medium. "It is a mistake," Mises emphasized, "to associate with the notion of free banking a state of affairs under which everybody is free to issue banknotes and to cheat the public ad libitum. People often refer to the dictum of an anonymous American quoted by [Thomas] Tooke: 'Free trade in banking is free trade in swindling.'" However, Mises noted, "freedom in the issuance of banknotes would have narrowed down the use of

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banknotes considerably" from the inflationary issues then current (Mises 1966: 446).

Mises very clearly intended his quotation of Tooke to be a foil for his emphasis of the true state of affairs that would develop under free banking. A little more thinking and Mises might have found Selgin's happy union between gold and free banking. But then what would Selgin have done?

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F. A. Hayek, on the Occasion of the Centenary of his Birth

Ronald Hamowy

At the time of his death, F.A. Hayek (1899–1992) was unquestionably the world's preeminent spokesman for classical liberalism and its most important thinker. He led an immensely productive life, over the course of which he made significant contributions to a variety of disciplines, among them economics, political and social theory, psychology, and the history of ideas. While his doctorate from the University of Vienna was in jurisprudence, his first interests were in economics and, to a lesser extent, in psychology. Hayek had done his work at the University under Friedrich Wieser and as a consequence had early adopted some of Wieser's socialist views. However, in 1922 Ludwig von Mises published his devastating critique of central planning (*Die Gemeinwirtschaft*), in which he demonstrated that in the absence of markets there exists no method of determining the values of goods and services and hence rational economic calculation becomes impossible. Indeed, the inevitable failure of socialism hinges on this central fact, that in the absence of a genuine price system, which requires truly free markets, planning boards are incapable of calculating real costs. Largely as a consequence of reading Mises, Hayek abandoned his early Fabian views and developed a close relationship with Mises, whose seminars Hayek began attending.

During a year-long visit to the United States, Hayek had become particularly interested in the relation between bank credit and the business cycle, and this interest eventuated in 1927 in Hayek's being appointed director of the newly created Institute for Business Cycle Research. Building on the theoretical framework earlier advanced by Mises in his *Theory of Money and Credit*, Hayek produced his first important work, *Monetary Theory and the Trade Cycle* (1929), in which he unraveled the relation between credit expansions and capital

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malinvestment that lay at the root of business cycles. The work was very well received and as a result Hayek was invited by Lionel Robbins to deliver a series of lectures at the London School of Economics on the trade cycle. Those lectures, which soon appeared in book form under the title *Prices and Production*, were received with such enthusiasm by the assembled faculty of the LSE that, as Ronald Coase has reported, they could speak of nothing else for months. Indeed, in their initial excitement some economists had concluded that Hayek had laid bare the underlying groundwork on which all public policy would henceforth have to be built. The immediate result was that Hayek was offered a chair at the LSE, the Tooke Professorship of Economic Science, which he took up at the age of 32.

The Primacy of Spontaneous Order

It is doubtless from this period that Hayek's love affair with England began. Hayek had already read widely in the history of ideas, but it was while in Great Britain that his conclusions regarding the nature of social relationships and law were more fully formed. Thoroughly familiar with the history of early economic thought, Hayek found in the writings of such writers as Adam Smith and David Hume the key to a theory that provided the philosophical underpinning for a free society. Much like Smith's description of the invisible hand as an unseen and undirected coordinating mechanism for the production and distribution of wealth, the writers of the Scottish Enlightenment, and particularly Adam Ferguson, had, Hayek found, offered an account of the rise of social institutions as the product of spontaneously generated orders. The theory, simply put, is that the social arrangements under which we live are of such an order of complexity that they cannot be the product of deliberate calculation but are, rather, the unintended consequence of countless individual actions, none of which aims at the establishment of coherent social institutions and many of which are the product of instinct and habit. In sum, one does not need an orderer to have order. Thus, language, law, morals, social conventions, and the exchange of goods and services are all instances of spontaneous orders. Indeed, Hayek regarded the view that social arrangements must be controlled by some central authority lest disorder and chaos ensue as the opening door to totalitarianism, no matter whether the directing authority was reactionary or socialist.

Both conservatism and socialism, Hayek contended, share this distrust of uncontrolled social action, in the same way both lack an understanding of economic forces. So central was the idea of the complexity of social orders to Hayek's thinking that it provided him

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what was probably his greatest insight in the field of economics, that in a *dirigiste* society there is simply no way to bring to bear the dispersed bits of knowledge possessed by economic actors that makes economic coordination possible. In two brilliant essays, the first published in 1937 ("Economics and Knowledge") and the second in 1945 ("The Use of Knowledge in Society"), Hayek points out that this division of knowledge is in fact the central problem of economics and that only free markets can provide this necessary coordinating structure.

Hayek's distrust of comprehensive theories of government and society followed directly upon his notions of the extraordinary complexity of social arrangements and the dispersion of knowledge. The history of the idea of liberty in England, Hayek contended, was essentially empirical and unsystematic and tended to rest on interpreting traditions and institutions that took their form without conscious direction. Most British theorists were aware, Hayek observed, that freedom itself was an artifact that grew out of these institutions and was no more natural to man than were the other trappings of civilization. French theories of a free society, on the other hand, tended to be more speculative and rationalistic, based on the assumption that the human mind could comprehend the totality of social arrangements and that it was, at least in principle, possible to restructure these institutions consistent with the social laws that human reason could uncover. In identifying these two traditions in the theory of liberty, the one British, the other French, Hayek sought to account for why continental political doctrine, stemming as it did from the French tradition, so easily slipped into totalitarianism. If one believes that human reason can lay bear the laws governing social arrangements, then one may with impunity thoroughly redesign society to one's liking.

The British tradition that Hayek so much admired was best exemplified by the writers of the Scottish Enlightenment, Adam Smith, Adam Ferguson, and above all David Hume. Joining them were a number of their 18th century contemporaries including Josiah Tucker, Edmund Burke, and William Paley, and the jurisprudential theorists of the common law. To these Hayek opposed the intellectuals of the French Enlightenment, which included the Encyclopedists, the Physiocrats, Condorcet, and especially Rousseau. Poisoned by Cartesian rationalism and appealing to men's pride and ambition, these writers regarded all social arrangements as the product of an ordering intelligence that political wisdom could reshape. Of course, as Hayek himself concedes, not all writers in the British tradition were British, nor were all those corrupted by rationalistic hubris French. Hobbes, Bentham and the other Philosophical Radicals, and the British supporters of the French

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Revolution, among them William Godwin, Thomas Paine, and Richard Price, all rejected the insights of the Scottish Enlightenment into the evolution of institutions under which men live. On the other hand, a number of French liberals fit more easily in the British tradition: Montesquieu, Benjamin Constant, and Alexis de Tocqueville.

Hayek's Liberalism

While I have some difficulty in accepting Hayek's model of the history of liberalism, I do think it casts light on where Hayek placed himself and why he regarded himself as a classical liberal. As such, Hayek could not fail to admire Locke, whose empiricism appealed to him. Certainly Hayek would have questioned the idea that government is ultimately the creature of a social contract, but Hayek's skepticism on the issue of natural law, like Hume's, was tempered by a rather sophisticated understanding of the nature of justice. While Hume, and Hayek after him, would have regarded the rules that comprise our notion of justice as the product of convention, these rules are not capricious but are, in fact, grounded in our nature as social animals born into a universe of scarce resources. We all share certain values by virtue of our living in a common environment, where the desires of all men exceed the means to satisfy them. It is this condition that gives rise to the fundamental rules of justice—what Hume had designated "the fundamental laws of nature." This is as close to Locke's conception of natural law as Hayek got, but it is close enough for him to embrace Locke as a true Whig.

Hayek enlarged on his criticism of the rationalistic approach to politics that characterized the French liberal tradition in a series of essays attacking the uncritical application of the methodology of the natural sciences to social questions. This scientistic analysis of society, common to all social planning schemes, errs in assuming that all social issues can be studied solely in terms of the observable behavior of individuals comprising the social whole, without reference to their subjective states of mind, and in asserting that we may make meaningful statements about social collectives independent of their constituent components. In a series of articles that originally appeared in the British journal *Economica* between 1942 and 1944 (later published in book form as *The Counter-Revolution of Science: Studies in the Abuse of Reason*), Hayek demonstrated that this fundamental methodological fallacy lies at the root of all social engineering. Tracing its roots to the view put forward by many French Enlightenment thinkers that all phenomena were in principle reducible to physics and that all social ills were curable through the application of reason, scientism

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found its fullest expression in the social physics of Henri de Saint-Simon and Auguste Comte and in Georg Hegel's scheme for a universal history of mankind. And from Comte and Hegel, this view descended to Karl Marx and his successors.

Hayek and Keynes

Hayek's concerns while at the London School of Economics were not, of course, confined to problems in social theory. Soon after arriving in London, Hayek found himself confronting Britain's (and possibly the world's) most celebrated economist, John Maynard Keynes. Keynes's *Treatise on Money* was published in 1930 and Lionel Robbins, at the time the editor of *Economica*, assigned the book to Hayek to review. Hayek's review, which was published in two parts, was sharply critical of Keynes's monetary theory, which, he pointed out, failed to appreciate the critical importance of monetary factors in altering the structure of production and in determining the trade cycle. Keynes replied to part one of Hayek's review, which appeared in August 1931, and, as editor of the *Economic Journal*, in turn selected Piero Sraffa of Cambridge to review Hayek's recently released *Prices and Production*, to which Hayek replied and Sraffa wrote a rejoinder. The debate between Keynes and Hayek soon spread throughout Great Britain and eventually involved every important economist then writing (including Sir Ralph Hawtry, Arthur Pigou, Sir Dennis Robertson, Arthur Marget, Alvin Hansen, and Herbert Tout).

It should not, by the way, be assumed that there developed a strong personal animosity between Hayek and Keynes because of their intellectual disagreements. Keynes apparently had an exceptionally engaging personality. He was quick, immensely witty, and an excellent raconteur, and, like most who met him, Hayek had early been charmed by his company, a charm that continued when the London School of Economics was moved to Cambridge early in the war as a consequence of the German bombing of the British capital.

Despite the fact that Keynes was later to concede the legitimacy of much of Hayek's criticism of his *Treatise*, the debate between the two economists was soon eclipsed by the publication of Keynes's *General Theory of Employment, Interest, and Money*. Released in 1936, at the height of the Depression, the academic world found in Keynes's recommendations regarding deficit spending and vigorous government activity a formula that had far more appeal than did Hayek's analysis of the causes of the business cycle and the need to allow the market to correct itself without more monetary intervention. The result was that Keynes's theory of underinvestment and undercon-

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sumption during periods of slow or negative economic growth came to dominate economic theory for several decades.

The Road to Serfdom

The 1930s and 40s, coincident with Hayek's tenure as professor at the LSE, witnessed a massive increase in government intervention in the economy coupled with ever greater intrusions into what had hitherto been regarded as one's private life. The growth of government was, of course, substantially accelerated after the outbreak of war in 1939. At the same time the prevailing English and American political orthodoxy viewed fascism and particularly National Socialism as philosophically antithetical to welfare socialism, which was commonly thought to be capitalism's benign reaction to the depredations of an unbridled market economy. Hayek became so alarmed by this commonly held view that he felt compelled to write his first work aimed at a lay audience, *The Road to Serfdom*. The essay appeared in 1944 and quickly became a cause célèbre, castigated by intellectuals on both sides of the Atlantic. Hayek there argued that the collectivist attitudes that had become so popular in the western democracies were, by virtue of their distrust of market forces and their contempt for individual decisionmaking, intimately related to fascism and that both had similar statist, anti-individualist roots. Central planning, Hayek claimed, by destroying the spontaneous order of the market, had of necessity resulted in a wide array of unforeseen and undesired consequences, which, in turn, had led to even more extensive planning and to yet further unsatisfactory outcomes.

The public notice that *The Road to Serfdom* received in the United States, where the book also appeared in condensed form in the *Reader's Digest*, led to Hayek's being invited on a lecture tour of American cities in mid-1945. His taste for America having been whetted by this trip, he was prevailed upon to accept an appointment on the Committee on Social Thought at the University of Chicago, which he took up in 1950. Hayek's appointment was to the Committee on Social Thought rather than to the Economics Department, his natural home, because the economists at Chicago regarded *The Road to Serfdom* and Hayek's other publications during the 1940s as either in areas not central to the problems of economic science as they understood them or as aimed at too popular an audience to be considered serious academic works. Hayek remained at Chicago until 1962, when he accepted an appointment as professor of economics at the University of Freiburg.

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The Constitution of Liberty

While Hayek published comparatively little in the field of pure economics during his tenure at Chicago, he did write a number of seminal works in a number of other disciplines, including psychology (*The Sensory Order*, 1952), the history of ideas (*The Counter-Revolution of Science*, 1952), economic history (the introductory essay to *Capitalism and the Historians*, 1954), and social philosophy (*The Constitution of Liberty*, 1960). *The Constitution of Liberty*, a theoretical treatise on the institutional foundations of a free society, was Hayek's most ambitious work. In its 570 pages, in which Hayek displayed truly breathtaking scholarship, he elaborated his theory of the interrelation between the rule of law and individual freedom and amplified his notion that the social arrangements under which men live are the product of spontaneously generated forces. By this, of course, Hayek did not in any way intend to rule out human intervention to ameliorate our condition or to improve our institutions. What he regarded as foolhardy was the idea that men could fashion complex social arrangements from the ground up and substitute these supposedly rationally designed institutions for those that had been build up over centuries, the product of numberless individual human interactions each of which sought some specific end distinct from the ordered arrangement to which it contributed.

Hayek as Mentor

It was immediately after the publication of *The Constitution of Liberty* that I met Hayek and had the pleasure of working under him. He was an extremely distinguished-looking man with impeccable manners and a gentle scholarly way about him. I confess to having found him somewhat formal, and although I grew to become quite fond of him and saw him a number of times after having received my doctorate, there always existed a wall, however tenuous, that separated professor from student. Indeed, I never ceased to call him professor even though I last met him when I was in my forties and had been a professor myself for a number of years.

Two things that struck me quite early about Hayek were his intellectual honesty and the modesty with which he wore his immense erudition. A close friend, Ralph Raico, had preceded me on the Committee on Social Thought by a year and was in residence working under Hayek when *The Constitution of Liberty* was first released. When I learned that I had been admitted to do graduate work there, Ralph presented me with a copy of Hayek's new book, with an inscription by the author: "As welcome to the Committee on Social Thought:

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F.A. Hayek." My response to Hayek's kind gesture was to devote my first few months at Chicago to writing an article attacking a crucial aspect of Hayek's theoretical framework, his analysis of the relation between freedom, coercion, and the rule of law. Not only did Hayek have the opportunity to read this attack but a number of others did as well, since it appeared as a book review in a new student periodical Ralph and I had started. At the time it did not strike me as inappropriate for a new graduate student to try to point out failings in the philosophical reasoning of his professor, but not only did Hayek read and discuss my critique with me, he offered to respond in print to my comments. It was only after I became a professor in my own right that I really appreciated the modesty and love of true scholarship that Hayek displayed toward me, some jumped-up graduate student who decided he was going to take on the very man he had chosen to work under. I'm still breathless when I think of the chutzpah that I must have had.

Because of the inadequacy of the pension arrangements Hayek had with the University of Chicago, he decided to return to Europe in the fall of 1962, when he assumed a professorship at the University of Freiburg. I had mentioned earlier that Hayek had an ongoing love affair with Great Britain. One of his proudest achievements was his having become a British subject during his tenure at the LSE, and he was disappointed that he did not have the opportunity to return to Britain. During the years I studied at Oxford I was able to see Hayek in London, to which he occasionally came. We would meet for a drink or lunch and he would tell me stories of his years in England and why he regarded the British as the most civilized people on earth. The British more than any other nation, Hayek contended, understood that true liberty rested on an appreciation for the rule of law and on the institutions that evolved to protect the subject's freedom from arbitrary power. They had a keen (but not a blind) respect for the unwritten rules governing how we should deal with each other, which allowed them to function as a cohesive entity even in a crisis, without relying on the explicit commands of some arbitrary authority.

But beyond this, he was struck by the quiet courage and dignity that the British displayed during the Second World War and particularly during the bombing of London. One day over lunch at the Reform Club he recounted to me how, at that very same table some years earlier, he had been having lunch with a colleague when the screech of a buzz bomb was heard getting louder and louder, a sure sign that it would land, if not directly on the Club, then close by. When conversation no longer became possible over the mounting noise the dining room fell silent and remained so until the bomb landed. At

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that point, Hayek recalled, each person picked up his comments at the exact point where he had earlier stopped speaking. There were no cries of alarm, no confused rush for the doors, no panic, and, equally important, no one barking out orders to the waiters and guests. In the event, the club that stood immediately to the west of the Reform was totally destroyed.

For some reason, that event and Hayek's tremendous pride in having been part of it stayed with me as an indication of Hayek's own modest dignity. When Hayek became a British subject he ceased styling himself in the central European manner as Friedrich August von Hayek but became F.A. Hayek, or "Fritz," as he was known to his close friends. He loved the British people and, above all, her philosophers of liberty, from the Whigs of the 18th century to the great liberals who followed them, especially Macaulay, Gladstone, and Lord Acton. All his writings in political and social philosophy attest to his admiration for things British. It was therefore somewhat of a surprise that he should have been recognized by the Nobel Committee for his brilliant contributions to economics but never to have been knighted by the Queen. But, doubtless, this disappointment was more than made up for by Hayek's having been fortunate enough to witness the complete collapse of the Soviet Union and the introduction of market ideas into Eastern Europe and to realize, as large numbers of Eastern European academics and intellectuals have attested, that his work played a crucial role in the revolutions that swept through the Eastern Bloc. If the world is a better place now than it was 20 years ago, at least some of the credit must be laid at Hayek's door. Beyond that, we have all been enriched by Hayek's contributions to our understanding of what makes a free society free.

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Hayek's Liberal Legacy

Stephen Macedo

One of the greatest achievements of humankind is to have discerned principles and institutions that allow diverse peoples to live together in freedom, peace, and prosperity. It may be that no one in the 20th century has done more to clarify and promote the principles of ordered liberty than F.A. Hayek, the centenary of whose birth was celebrated at the Cato Institute on May 8th. I am pleased to have the opportunity to say something here about the central elements of Hayek's intellectual legacy, concentrating on what Hayek contributed to the intellectual underpinnings of the principles of a free society.

Three broad themes seem to me to qualify as central elements of Hayek's legacy. First is Hayek's critique of political utopianism, which rested on his development of the theory of spontaneous order and his closely related account of the limits of conscious human knowledge. Second is Hayek's emphasis on the interdependence of law and liberty: his classical liberal conception of the rule of law, in which what is absolutely essential to modern government is the defense of a broad law-governed sphere of individual liberty. Finally, I want to stress that in spite of Hayek's insistence on the limits of human knowledge, he displayed a profound faith in the power of ideas and institutions. Whereas the first two elements represent points of similarity with thinkers who are in important ways more conservative—such as Michael Oakeshott (1962)—Hayek emerges as a figure squarely in the liberal tradition when one considers his confidence in the power of public ideas, his commitment to an ever wider extension of liberal institutions, and his faith in human progress. In conclusion, I will discuss a few of the problems with which Hayek's ideas leave us.

My aim here is not to pinpoint the originality of particular elements in Hayek's thought: I will not try to isolate those things that Hayek

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thought of first. Rather, I will focus on Hayek's power and incredible influence as someone who dedicated himself for the latter half of his long life to the project of restating in persuasive terms the central elements of the theory of the free society. Overall this seems to me to be Hayek's greatest achievement. In spite of his disdain for mere "intellectuals," Hayek was himself not solely but most definitely a great public intellectual who helped spread the principles of modern freedom, and who helped propel those principles into the future with considerably greater momentum than they would have had without his influence.

The Notion of Spontaneous Order

The first aspect of modern freedom that Hayek did much to describe and clarify is the notion of spontaneous order, an idea that was first expounded by the great luminaries of the Scottish Enlightenment, Adam Smith, David Hume, and Adam Ferguson. As Ronald Hamowy describes in his essay in this volume, spontaneous orders include not only markets, but languages, moral systems, and systems of law, all of which emerge as the unintended byproduct of innumerable individual interactions, interactions that aim at particular results for individuals. Individuals pursuing their own purposes do not aim to promote an overall pattern of order, but they learn to conform with shared norms and constraints so that their interactions and exchanges will be orderly and successful (see Hayek 1960, chap. 4, and Hayek 1988, chap. 5).

Spontaneous order is the product of human action but not of human design. It is not a willed, created order. Unlike Thomas Hobbes, Hayek did not posit the need for a sovereign to create order out of chaos. And strikingly, in the last pages of his final book, *The Fatal Conceit*, Hayek (1988: 139–40) confesses that he can make no sense of the notion of a divine will that is responsible for order as we know it. The notion of God as final cause of order in the universe is portrayed by Hayek to be a piece of arrogant anthropomorphism: "The conception of a man-like or mind-like acting being appears to me rather the product of an arrogant overestimation of the capacities of a man-like mind. I cannot," he went on, "attach meaning to words that in the structure of my own thinking, or in my picture of the world, have no place that would give them meaning." "The source of order," says Hayek in this profession of agnosticism, is "not outside the physical world but one of its characteristics."

The central error of much modern thought, for Hayek, is the "hubris of reason" that characterizes "constuctivist rationalism": this is the doctrine that all orders are made or designed, and that they can be

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redesigned or remade at will to serve conscious purposes. Hayek emphasizes the extent of human ignorance, especially with respect to the decisions of particular individuals. People pursuing their own purposes act on the basis of local knowledge, preferences, and dispositions that they could not fully formulate to themselves, let alone disclose to some central authority. Market prices as well as social norms emerge as a result of innumerable individual decisions. Because of the inevitable importance of tacit and unconscious knowledge, markets make use of knowledge that certainly surpasses what could be gathered by a central authority intent on imposing a consciously ordered pattern (see Hayek 1948, especially "The Uses of Knowledge in Society," and Hayek 1988, chap. 5).

Because of the importance of decentralized decisionmaking in spontaneous orders, interventions into economic and social systems often have unintended consequences, consequences that are often quite the reverse of what is intended. Examples are not hard to generate. Metropolitan areas around the country continue to suffer the debilitating consequences of well-meaning government interventions that have had the unintended effect of undermining many of the most attractive features of older cities, including informal neighborly interactions and lively public places. It might seem that suburban sprawl and the decline of older urban neighborhoods are the natural consequences of the economic progress made by many of those ethnic groups who had once inhabited urban ghettos. However, the unintended consequences of government policy have played a major role in producing the urban blight and suburban sprawl whose costs are only now being adequately assayed.

Consider the variety of ways in which governments tried to promote home ownership, create green spaces, and discourage urban crowding. As Edward Banfield ([1974] 1990) pointed out in his classic study, *The Unheavenly City*, the fact that the federal gasoline tax was devoted to highway construction helped subsidize the residential migration out of cities. In addition, the home mortgage tax deduction provides an incentive to build and occupy larger homes. Richard Moe and Carter Wilkie (1997) have emphasized the extent to which Federal Housing Administration policies with respect to mortgage guarantees have further encouraged the construction of suburban subdivisions at the expense of the renovation of older urban neighborhoods. FHA mortgage guarantee programs reflected a strong preference for predictable and stable housing values, which are most easily achieved in new and uniform suburban subdivisions. The FHA has in this way contributed to urban blight and suburban sprawl. More than that, all of these policies have encouraged the movement of middle class

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people out of cities, which has greatly exacerbated class and racial divisions in our society.

Zoning laws have also contributed to undermining informal interactions in cities and suburbs. Zoning laws require homes to be pushed back from the street, minimum housing lot sizes, and the segregation of businesses and residences. They also typically require that businesses surround themselves with belts of parking lots and green spaces. Such laws discourage walking and informal neighborly interaction. They place a premium on automobile use, and further encourage economic segregation (Kuntsler 1998).

My point here is not that all regulation of property use is necessarily a bad idea, but that interventions in complex, evolving social systems are fraught with peril. Among the great complaints of our time is the decline of neighborhoods and neighborliness, of informal social ties, voluntary cooperation, and mutual aid. There is no doubt in my mind that well-intended but misguided government interventions have had a significant deleterious impact on the quality of civil society in metropolitan areas: without intending it, governments have positively encouraged urban decline and class and racial division.[1]

Hayek's Attack on Social Justice

The socialists' dream that central economic planning could supplant free markets turned out to be a catastrophic nightmare, a "fatal conceit" as Hayek put it in the title of his final book. No one has or could have sufficient knowledge to plan an economy, make production decisions, or efficiently allocate resources. Free competition in the market is a far more effective way to coordinate prices and production because markets take account of dispersed knowledge.

There was an additional way in which Hayek regarded the moral aspirations of not simply socialists but also social democrats as deeply mistaken. Hayek argued that to talk of "social justice" is absurd, and to try and promote a just distribution of economic rewards is utterly misguided. The reason is that economic rewards are part of a vast unplanned system. No person or entity distributes awards. The pattern of rewards that results from market exchanges is the consequence of innumerable individual decisions, and these results are often quite arbitrary. Success or failure in the market may depend partly on effort, skill, and merit, but they often depend crucially on luck and unforeseeable events, and the actions of other people in far-flung corners of the globe (see Hayek 1978).

[1]I explore these ideas at greater length in a book manuscript in progress on liberalism, civil society, and public policy.

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One of Hayek's central and distinctive claims is that the notion of distributive justice makes no sense: The call for social justice anthropomorphizes what is in reality an impersonal market order. No one is responsible for the overall pattern of distribution that the market produces. We must accept the outcome of the market order, moreover, or else risk upsetting a system that on the whole provides the best chance of satisfying people's expectations overall.

Hayek shares the sense of John Rawls (1971) and other social democrats that market outcomes are arbitrary from a moral point of view: they conform to no moral standard. But Hayek insists that we must accept and live with the contingency of market outcomes in order to garner the benefits of the market. As he puts it,

> We do cry out against the injustice when a succession of calamities befalls one family while another steadily prospers, when a meritorious effort is frustrated by some unforeseeable accident, and particularly if of many people whose endeavors seem equally great, some succeed brilliantly while others utterly fail. It is certainly tragic to see the failure of the most meritorious efforts of parents to bring up their children, of young men to build a career, or of an explorer or scientist pursuing a brilliant idea. And we will protest against such a fate although we do not know anyone who is to blame for it, or any way in which such disappointments can be prevented [Hayek 1978: 68–69].

Hayek argued that these observations apply to markets in general: market outcomes are often morally arbitrary, but no one is to blame. "'Social justice' is necessarily empty and meaningless," because no one determines the relative incomes of people, and no one can prevent their incomes from being "partly dependent on accident" (Hayek 1978: 68–69).

Socialists err in refusing to accept the necessary contingency of distributive patterns. Hayek, on the other hand, opposes attempts to impose distributive patterns not out of a belief in natural rights to property but rather based on the nature of a spontaneous order that serves to maximize the fulfillment of people's expectations as a whole.

Hayek's attack on the notion of social justice is at best only partially successful. He is certainly right that the law of unintended consequences counsels skepticism about comprehensive attempts to control and plan complex social and economic systems. Socialism does indeed appear to be impossible, at least insofar as it is understood as the aspiration to a comprehensively planned economy. Hayek is correct to assert, moreover, that no one is responsible for the pattern of economic distribution that results from the market.

Nevertheless, as Judith Shklar (1990) argued against Hayek, the notion of social justice is not founded on the error that some person

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or entity is responsible for bringing about distributive inequalities. Rather, it is founded on the notion that we can collectively intervene if we choose to do so, through democratic means. And our interventions need not, of course, take the form of comprehensive economic planning, but may take the form of more modest efforts to promote universal access to certain basic benefits (such as health care, education, unemployment insurance, housing, and perhaps a minimum income). If we decide not to intervene collectively to equalize income or even simply to provide a basic safety net, Shklar rightly argued that we need some positive justification. It is not up to us how the market allocates rewards, but it is up to us how we respond to that allocation. While Hayek's development of the idea of spontaneous order is important and successful, his attempt to explode the "myth of social justice" is less so.[2]

Let me add that various forms of egalitarian social justice may still be a bad idea—depending on how it is formulated and implemented it may undermine the character of aid recipients, for example—but it is not a bad idea for Hayek's main reason, which is that the very notion of social justice is an absurdity.

The Rule of Law

The second major element of Hayek's legacy is his classical liberal conception of the rule of law. The law of property, contract, and torts provides a system of impartial rules that serve as a framework within which individuals and voluntary groups can pursue their own divergent ends and purposes, their own conception of what constitutes a good life. The rule of law so understood is central to any account of freedom in modern mass societies, and Hayek's exposition is probably the most important and influential version produced in the 20th century.[3] Like other thinkers who sought to systematize an account of the rule of law at mid-century—thinkers such as Lon Fuller (1969) and Michael Oakeshott (1984)—Hayek wanted to emphasize the essential nature of the rule of law as a bulwark of liberty. All of these thinkers insist that the rule of law system is noninstrumental or purposeless (see Macedo 1985). A well-ordered system of law does not prescribe to individuals what they should do, but rather tells them how to do whatever they wish to do. The rule of law prescribes "adverbial" conditions on self-chosen actions, as Oakeshott put it.

[2]See the valuable discussion of this and other problems in Hayek's thinking in Kukathas (1989).

[3]Hayek's most extensive exposition is in *Law, Legislation, and Liberty*, especially volume 1, *Rules and Order* (Hayek 1973).

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A free society ordered by the rule of law does not, according to Hayek and other classical liberals, need a hierarchy of ends or purposes. Generally applicable standing rules—like the rules of the road—help individuals avoid collisions and avoid conflicts over scarce resources, and allow people to make legally binding commitments to one another. And, like the rules of the road, the rule of law for its classical liberal defenders does not prescribe a destination but rather a way for individuals to get where they want to go. An ordered system of individual liberty is simply inconceivable in a modern mass society without a rule of law that incorporates the elements Hayek describes.

Clearly, the rule of law helps underpin the notion of spontaneous order. The rule of law allows individuals to adapt to changing circumstances, to use their local knowledge, pursue their individual purposes, and engage in exchanges and voluntary cooperative relations with other people. Society as a whole adapts to changing conditions in this way without anyone directing the process from above. We count on government to enforce the rights of ownership and legally binding contracts, and to punish breaches of the law. But the rule of law crucially depends upon getting governments to respect the private rights of individuals, to refrain from arbitrary exercises of power. The free society requires (according to the classical liberals) government agencies to enforce the law, and to abide by the limits of a higher, constitutional law. Clearly, therefore, the central features of Hayek's version of classical liberalism—spontaneous order, the rule of law, individual liberty, and limited government—are all closely intertwined.

It was extremely important for Hayek to be clear about the nature of law properly so-called—an evolved system of enabling rules. Hayek—once again like Oakeshott and Fuller—sharply distinguishes this freedom-facilitating notion of the rule of law from the principles of an organization or enterprise, which acts in a concerted way for specific purposes. The rule of law properly speaking is to be distinguished from government policies designed and promulgated for the pursuit of particular aims, or to provide specific services. In order to sharpen this distinction in practice, Hayek argues that the universal rules of just conduct that compose the rule of law should be made by a distinctive legislative body, and that body should be constituted so as to be independent of partial interests and of most of politics as we know it. For this legislative body Hayek proposes 15-year terms and no reeligibility for office (see Hayek 1973).

Hayek's distinction between law and legislation, and his insistence on the indispensability of law to modern freedom, do not of course allow us to sharply define the limits of what government may do: which public services may be provided, how extensive a safety net

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should exist, and so on. All of those political interventions could be developed fairly extensively while respecting the integrity of the rule of law, while remaining far short of any comprehensive effort to plan the society as a whole (as socialism attempted to do), and while remaining cognizant of the dangers of unintended consequences.

Social Evolution

The notions of spontaneous order and the rule of law are the core of Hayek's theory of the free society. These institutions allow individuals to draw on dispersed knowledge, pursue their purposes, and adjust to circumstances in their own way. And these institutions allow society as a whole to engage in unplanned evolutionary progress. The free society is capable of flexibly adapting to changing circumstances. Hayek (1988: 74) argues that free institutions have been selected by a process of evolutionary adaptation because they are successful: successful social adaptation helps "make the group strong," and permits it to "prevail over others."

This raises an important question: What constitutes a successful society and how do we discern and justify the criteria of success? Hayek often emphasizes that progress occurs through a process of evolution according to which those societies that are relatively successful will tend to favor successful social norms that foster adaptation to change and support growing populations. Even moral traditions are, Hayek (1988: 10) argues, the product of cultural evolution rather than the deliverance of reason.

The emphasis on evolutionary change raises important questions that Hayek never adequately addresses: What are the standards by which we judge the evolutionary process? Given the limits of human knowledge, can we even presume to judge the outcomes of the process of social evolution as a whole? How can we do so if moral standards are themselves, as Hayek emphasizes, the product of evolution? Are there articulable and rationally defensible moral standards beyond the evolutionary dynamic, standards that give us critical leverage over the evolutionary process and allow us to pass judgments on outcomes? Or does Hayek's critique of constructivist rationalism mean that we must not presume to judge the results of the evolutionary process? Are there, indeed, any features of the system that should not evolve? Are there principles of justice that we should protect against change, or is the evolutionary process as a whole—like the pattern of economic distribution—morally arbitrary?

These questions are important, for there are times when Hayek sounds like a moral skeptic who believes that the moral values selected

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by social evolution should be adhered to even though they appear as no more than "unreasoned prejudice," and that evolved moral traditions "outstrip the capacities of reason" (Hayek 1988, chap. 4).[4]

Power of Public Ideas

Here then is where I come to the third element in Hayek's legacy, which is his confidence in the power of public ideas—a confidence that is ultimately at odds with a blind faith in social evolution. Hayek's vision of the free society is, indeed, infused by an implicit set of moral standards, judgments about many aspects of the social system as a whole.

If the evolutionary dynamic was basic, then liberalism itself might be simply a stage in the evolutionary progression—merely a temporary and a local ideal. But surely we would not want to say, and Hayek would not say, that our confidence in the superiority of the free society to fascism and communism rests on the fact that we prevailed over these abhorrent systems in World War II and the Cold War. To say that the free society is superior because it proved itself stronger and fitter in war is to adopt the moral standards of the very tyrants we oppose. To say such a thing would be to concede that fascism, communism, and the free society ultimately share the same standards of success: the ability to prevail over others.

To avoid the moral reductionism of "survival of the fittest," we need to bring to the surface the principles that underlie the evolutionary emphasis in Hayek's thinking. The evolution that he seeks to foster is, after all, the evolution of a spontaneous order, which is not simply an unplanned order but a freely adapting order *governed by the primacy of individual liberty*. Evolution works by allowing free individuals to adapt, but the political system should remain constantly true to certain basic values, such as the equal right to individual liberty, the security of privacy and property, and freedom of association, all of which are importantly guaranteed by an impartial and regularly administered rule of law. So the evolution Hayek favors is a constrained form of evolution: a process of peaceful and free adaptation, consistent with ordered and responsible individual liberty.

None of this is surprising because Hayek is far from being a skeptic or agnostic with respect to the question of how society as a whole should be organized. Hayek has a plan for the good society as a whole, a definite account of how its major political and economic institutions should work. The free and progressive society is a particular type of

[4]See the discussion in Kukathas (1989, chap. 5).

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society. Indeed, this ideal society appears to be a universal ideal for Hayek, albeit one according to which production, employment, and spending decisions are best left to individuals.

Whereas the more conservative rule of law theorist Michael Oakeshott rejected the notion of a theoretically grounded political practice, and described politics as the "pursuit of intimations," Hayek has a much more elaborate theory of the good society, and he is far more insistently prescriptive than was Oakeshott.

Let us sharpen this point by returning to an earlier observation: it did not simply matter *that* we should prevail over fascism in World War II. It also mattered *how* we did so, and this is something Hayek himself insisted upon.

On this score, Australian political theorist Chandran Kukathas discusses some fascinating materials in the Hayek archives: some "Notes on Propaganda" that Hayek composed early on in World War II, and a variety of letters he wrote to British officers in charge of propaganda efforts directed at the people of Germany and Austria. These revealing—but unsolicited—notes and letters contain Hayek's thinking about how propaganda should be conducted during the war.[5] In them, Hayek emphasizes two things: First, propaganda should be truthful and accurate ("truthful" propaganda sounds like a contradiction in terms, but so be it). The aim should be to describe the principles of liberty and democracy and to describe in sober and dispassionate terms the discreditable acts of the Nazi regime. Hayek admitted that this notion of propaganda might sound academic, but he insisted—even in the darkest hours of 1939—that the important thing was to tell the truth, to admit mistakes when they occurred, and to provide details—names and dates of people committing atrocities—to furnish overwhelming evidence of the depravity of the Nazi regime. So even with regard to wartime propaganda, Hayek urges that the free society should remain true to its own principles of truthfulness. Even in wartime, as Kukathas observes, Hayek insisted on the importance and power of honesty.

Secondly, Hayek also saw a crucial aim of wartime propaganda as that of strengthening the internal forces of German resistance to Nazism. Fostering resistance was not simply important as a way to undermine the German war machine, but also to begin the process of

[5]My account here is entirely drawn from Chandran Kukathas, "Hayek and Modern Liberalism," unpublished paper, on file with the author. Kukathas summarizes and quotes unpublished materials that can be found in the Hayek Archive at the Hoover Institution Library, Stanford University, California: F.A. Hayek, Box 6, folders 4 and 5, especially "Some Notes on Propaganda in Germany," Folder 4, and letters to Ogilvie, Macmillan, and Gifford, folders 4 and 5.

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German reintegration into the common European civilization. Hayek opposed any sort of fatalism about the German character. In these wartime notes and in a paper he delivered in early 1944, Hayek insisted that the great danger was falling prey to fatalism about historical developments in central Europe. A common European civilization could be rebuilt if the moral ideals of liberal democracy could be restated in persuasive terms. In mankind's darkest hour, therefore, Hayek insisted that the struggle against mankind's greatest evil should be carried on in such a way as was consistent with the civilized aspiration to reinstate an ever-widening circle of peaceful cooperation and reasonableness.

And indeed, Hayek dedicates much of the rest of his long life to restating in persuasive but honest terms the principles of the free society. He does so with the conviction that the fate of freedom depends on making a critical mass of scholars, intellectuals, and ordinary people aware of the principles at the core of the liberal tradition.

So Hayek dedicates *The Road to Serfdom* to "socialists of all parties" because he regards them as well-meaning but misguided people who are wrong about the workings of a free society but who, Hayek is willing generously to presume, are as open as he is to evidence and honest argument. How striking is this generosity of spirit. Hayek is both more hopeful and more universal than typical conservatives with whom he is often compared. And he is far more generous and gentlemanly in his treatment of his opponents than is typically the case in politics nowadays, where the rule is to demonize over small differences.

As Kukathas rightly emphasizes, Hayek has provided us with a body of thought that looks forward to the extension of the principles of the free society to developing nations around the globe. He founds an international society of scholars after the war—the Mount Pelerin Society—to help realize his goals. And he plays a crucial role in inspiring others to establish and sustain many other institutions dedicated to free inquiry and rigorous scholarship about liberal principles and public policy: The Institute for Humane Studies, Liberty Fund, the Atlas Foundation, the Institute for Economic Affairs, along with similar organizations that circle the globe, and of course, the Cato Institute.

Hayek's Legacy

F.A. Hayek's legacy lies not in any sort of moral skepticism. He was no blind adherent of social evolution. Rather, he argued for the limits of human knowledge while at the same time advancing a positive

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account of how human knowledge can be most effectively generated and harnessed in an extended order of free and peaceful international cooperation.

Skepticism is not, after all, the best, or even a credible, response to the great evils of the 20th century, as Hayek well knew. The essential linchpin of Hayek's thinking, it seems to me, is a sober confidence in critical human reason. Hayek's life and his inspiring success testify to a warranted confidence in our ability to articulate, defend, and extend liberal principles. It is this faith in the attractiveness of the principles of liberty honestly stated that is Hayek's greatest legacy. That legacy lives on not only in the contagious hopefulness of Hayek's best writings, but in the hearts and minds of millions who have been touched and inspired by those writings.

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The Unintended Consequences of Regulating Addictive Substances

Adam Gifford Jr.

Former Food and Drug Commissioner David Kessler, former Surgeon General C. Everett Koop, and a legion of others argue that significant government regulation is needed to protect consumers from nicotine, which has been shown to be addictive, and from smoking, which increases the risk of lung cancer, heart disease, and a host of other health problems. The biology and the economics of addiction, however, suggest that government regulation can result in harmful unintended consequences to the consumers of potentially addictive substances.

Adverse policy consequences result from the workings of the biological mechanisms of addiction. Specifically, addictive substances activate the motivational area of the brain, an area that allows animals, including humans, to use environmental cues to predict rewards. As part of the motivational process, the cues become a *desirable complementary* component of the process of acquiring the reward. Additionally, the consumption of addictive goods tends to lead to "set-point" behavior where the individual will attempt to maintain the set-point level of blood and brain concentrations of the active substance. As the set point is determined in part by the initial consumption history, higher levels of initial consumption, for example, lead to a higher set point. The complementary and set-point characteristics of the consumption of addictive substances interact with various substitution effects predicted by economic theory and result in negative consequences.

Motivation, Value, and Association

Reinforcement of behavior depends on a goal-directed arousal system in the brain that is responsible for learning at a basic level, and

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this learning involves the creation of memories necessary for the survival of individuals and species. According to Heather Ashton (1992: 83):

> The idea of a goal-directed arousal system in the brain implies the existence of some mechanism for selecting appropriate goals, for initiating the behaviours required to achieve them, and for signaling when they have been attained. If a goal proves favourable for survival in the prevailing circumstances, it is advantageous to reinforce behaviour leading to it; if the goal proves to be unfavourable, behaviour leading to it must be suppressed and avoidance action taken in the future.

This motivational system allows creatures from bees to humans to take the measure of their environment in a very specific and sophisticated fashion. When an animal finds and consumes a good, a value—in economic terms, a marginal value—becomes attached to an internal representation of that good. This value is based on the ability of a good to enhance the fitness of an individual—that is, to increase the likelihood that an individual will survive and procreate (see Edelman 1992: 100). Furthermore, associations will be created between the good, its value, and characteristics such as location, complementary goods, and other environmental cues. In this example, the location where the good was found will be stored in memory, subject to recall when the animal seeks the good in the future. The associated goods and cues are used by the animal to predict when and where the primary reinforcing good can be found. Since the probability of finding a good in this same location in the future is uncertain, the motivational system enables the animal to form expectations about the probability of finding it there in the future. Expectations about associated or complementary cues and about the ability of a good to enhance fitness are formed and stored during a learning process, and the values attached to these expectations motivate behavior and generally allow the animal to organize that behavior in an efficient manner. The addictive properties of certain substances are a result of their effects on the motivation-reinforcement system.

Addictive substances are defined as those that activate these reinforcing systems (see Ashton 1992: 104–6; Carlson 1994: 582–93; Kupfermann and Schwartz 1995: 626; and Pinel 1993: 444–53). However, the activation of the reinforcement area of the brain by psychotropic substances is generally different from its activation by ordinary reinforcing goods such as food. Food, for example, is only reinforcing when an animal is hungry—only a hungry animal will seek a location where, from past experience, it expects to find food (see Carlson 1994: 472). Addictive substances seem to be much more capable of

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reinforcement effects, independent of the animal's internal state. Also, the value assigned to an ordinary good reflects its expected ability to enhance the animal's fitness. The values assigned to potentially addictive goods may exceed the value that measures the ability of the good to satisfy these requirements.

The associated or complementary goods and cues by themselves will begin to activate the motivational area of the brain; they become conditioned reinforcers (see Carlson 1994: 472).[1] These associations can be positive, as with the association of a good bottle of wine with a fine meal. The associations can also be adverse, such as when smoking and drinking alcohol become associated, making it difficult to quit one activity without quitting the other (see Gulliver et al. 1995: 202–6). Similarly, the sight of the needle used to inject heroin can become associated by reinforcement with the effects of the drug itself, so that simply seeing a needle can stimulate craving for the drug. And an associated location or social environment, for example, back alley needle sharing, can even become a sought-after aspect of the consumption of heroin.

The Set-Point Mechanism

In a recent set of experiments Ahmed and Koob (1998: 299) found that rats allowed to self-administer cocaine "regulated their intoxication around some endogenous reference or 'hedonic set point.'" The initial consumption history, in part, determined the level of the set point.[2] Animals given longer initial access periods to the drug escalated use over time and reached a higher set point then those with shorter access. For both low- and high-set-point animals "decreasing the [concentration of each] dose produced an increase in cocaine self-infusions," so that the rats could attain their set-point concentration levels in response to the diminished concentration of each dose (Ahmed and Koob 1998: 299). The same response has been seen in

[1]Montague, Dayan, and Sejnowski (1996) develop and test a computational model of the motivational area of the brain. In their model, "a set of sensory cues associated with the administration of . . . [psychotropic] compounds would predict an effect [on the motivational area] attributable partially to . . . [that of, for example,] cocaine" (p. 1945). They explicitly model the process by which the cues become conditioned reinforcers. For a general review and discussion of this model, see Schultz, Dayan, and Montague (1997).

[2]Various set-point or homeostatic mechanisms in the body regulate, for example, temperature, feeding, and responses to thirst. Body weight is regulated by a set point that can become destabilized in a manner similar to the set-point mechanisms that control the intake of potentially addictive substances. Short-term destabilization of both the body weight and the addictive substance set points can result in bingeing behavior—this is not surprising since both regulatory processes rely on an overlapping set of mechanisms (see Kupfermann and Schwartz 1995: 613–27).

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human smokers, where "dependent smokers adjust their smoking to maintain constant blood and brain nicotine concentrations" (Pianezza, Sellers, and Tyndale 1998: 750).

What the set-point response suggests for cigarette regulation is that if regulation mandated lower nicotine levels in cigarettes, individuals would simply adjust their smoking behavior to return their blood and brain nicotine concentrations to their set-point level by increasing the volume and depth of inhalations or the number of cigarettes smoked in a given period of time. The extent to which the smoker uses one or both of these methods to maintain nicotine concentration levels will depend on, among other factors, the economic costs of each method. Both methods will increase the harmful effects of smoking resulting from the absorption of nitrosamines, collectively referred to as tars, and from the absorption of carbon monoxide.[3] Ironically, then, one of the results of reducing the nicotine levels in cigarettes is a potential increase in the injurious effects of smoking caused by tars and other harmful substances. It seems that this effect could, in part, be alleviated by reducing nitrosamine levels. However, it is primarily the tars that give cigarettes their taste and, in dependent smokers, that taste becomes associated with the pleasure of smoking by the reinforcing effects of nicotine. Like needle sharing, the associated taste becomes a feature of smoking sought after for its own sake. Consequently, reduced-tar cigarettes are not popular with smokers. In fact, it is possible that a set point for tar concentrations could result from the association effects of reinforcement. In the next section, the effects of the interaction of set-point behavior and excise taxes will be discussed.

An often implicit assumption of those who argue in favor of the government regulation of addictive substances is that their consumption yields few or no benefits to the consumer. Though most economists reject this conclusion, I want to mention a few of the known biological benefits derived from consuming various psychotropic substances. One of the effects of many of these substances, including alcohol, barbiturates, heroin, tobacco, and marijuana, is that they reduce anxiety. Further, alcohol reduces inhibitions, and while this effect can sometimes result in trouble, by reducing social anxiety it probably increases the enjoyment of many individuals in certain social settings. Reduced cognitive activity is an effect related to the consumption of various psychotropic substances, and another suggested effect on individuals is short-term "myopia for the future" (Damasio 1994:

[3]Cigarette smoke contains a number of other potentially harmful substances, including formaldehyde and cyanide (Fowler et al. 1996: 735).

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218). All of these effects can be considered beneficial if not carried to the extreme, since they allow the individual a temporary respite from social anxieties and other cares, and they probably explain why most societies past and present have their equivalent of the six pack or glass of wine.[4]

Interestingly, some substances can be said to increase cognitive ability by increasing alertness. Since some minimum level of alertness is necessary for rationality, substances like nicotine, caffeine, and even cocaine taken in small doses yield utility by increasing alertness and thus could be said actually to enhance rational thought. Of course, in larger doses cocaine can make users feel more rational and powerful than they actually are, and this can create problems. One of the interesting aspects of smoking is that there is evidence that it enhances memory formation and may be useful in enhancing the memories of Alzheimer's patients (Gray et al. 1996: 713–16) Smoking may also result in a lower incidence of Parkinson's disease and can relieve some of its symptoms (Fowler et al. 1996: 735).

Evidence of the Effects of Regulatory Policy

When the state makes the decision to regulate the consumption of a psychotropic substance, it has several policy tools it can use. It can use taxes, including taxes set so high that they drive legal provision to zero; it can use outright prohibition; and finally it can turn to a modern innovation—it can allow and encourage the use of the legal system to sue the legal producers of addictive substances out of the market. Increasing the "cost" of the legal consumption and production of potentially addictive substances by the various regulatory means will result in substitutions along several margins. The effects of these substitutions combined with the biological properties discussed above are the topic of this section.

A few examples will serve to illustrate the perverse effects of the state's attempt to regulate addictive substances. In 1644 the emperor of China banned the smoking of tobacco, which resulted in many Chinese smokers switching to opium (Pinel 1993: 438). The Harrison Narcotics Act of 1914 made it illegal in the United States to sell or

[4]Andrew Sherratt (1997) has examined the use of alcohol, opium, and hemp derivatives dating back to the 5th millennium BCE. Sherratt argues, from the archeological evidence, that alcohol was used in "social contexts . . . when [it was] introduced" (p. 389). Further, "the introduction of alcoholic drinks, with their properties of intoxication and the generation of conviviality—a socially accepted alteration of consciousness—is a major event for any society" (p. 391). "What we are actually looking at is the origin of a tradition of alcohol-based hospitality" (p. 392).

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use opium, morphine, or cocaine. As a result many opium addicts switched to the more highly addictive heroin, which was not covered by the act (Pinel 1993: 439). Crack cocaine, introduced as a cheaper alternative to regular cocaine in the 1980s, partly in response to the increases in street prices brought about by the War on Drugs, "is probably the most effective reinforcer of all available drugs" (Carlson 1994: 585). The search for possible legal substitutes for various psychotropic drugs led to the introduction of so-called designer drugs. In 1992 a contaminated batch of these designer drugs resulted in several individuals developing the symptoms of severe Parkinson's disease—the victims froze up and could not talk or move (Youdim and Riederer 1997). And in the second half of the 19th century, high taxes on whisky in the United States led many individuals to substitute opium and hashish (Hu 1950: 40). Obviously, attempts to regulate along one margin simply lead to a shift to another, and often the substitute product is a more highly concentrated form than the one it replaced and thus potentially more harmful. Furthermore, a potential effect of the consumption of substances with higher concentration levels of their active ingredient will be a higher set point than would otherwise be the case, and, as a result, regulation may increase the average severity of the addiction problem for users of potentially addictive substances.

In sum, prohibition results in substitutions along several margins, most of which, when coupled with biology effects, work in the opposite direction of the goal of reducing harmful outcomes. Prohibition has adverse effects that complicate the addiction problem. By increasing concentrations, it increases the reinforcing strength of substances and thus is more likely to lead to naïve users quickly becoming addicted and increase the severity of the addiction resulting from increasing the set point. Also, variations in the quality and concentration increase the difficulty of the learning problem faced by naive users—for example, unanticipated variations in concentration can lead to fatal overdoses. Our experience with the prohibition of alcohol illustrates these points.

After the passage of the 18th Amendment and an adjustment period, alcohol consumption was reduced by only a third over pre-Prohibition consumption when measured in units of pure alcohol. The adjustment period resulted from the time lag in the establishment of extensive sources of illegal supply. Of equal importance was a significant shift in the composition of consumption away from beer and toward more highly concentrated forms of delivery, wine, and distilled spirits (Hu 1950: 52–54). This shift in consumption to stronger and more concentrated forms of a reinforcing substance affects the

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strength of reinforcement, as well as the association/complementary and set-point effects. In a more recent example, there has been a proliferation of intensive indoor cultivation of marijuana, which has resulted in as much as a fourfold increase in the levels of THC, the active chemical, of the product sold on the street (Navarro 1996).

The shift in concentration brought about by prohibition might be called the Alchian and Allen Effect, since it is a result similar to their proposition that fixed shipping costs skew the quality mix of shipped goods toward higher quality (Alchian and Allen 1983: 36; see Gifford 1997 for a more detailed discussion of these points). The penalties associated with getting caught with many illegal substances like opiates do not vary significantly with their concentration. Like a shipping cost, the penalty will skew the mix of smuggled goods toward more highly concentrated forms of the substance that will have a higher market value per pound or for a given bulk. The actual shipping costs also contribute to the shift toward higher concentrations. These effects are compounded by the fact that higher concentration levels are more easily concealed. Furthermore, by significantly reducing the value of seller brand-name capital, prohibition tends to increase the variance of the quality and strength of addictive substances.

Miron and Zwiebel (1991) estimate the effects of the 18th Amendment on alcohol consumption using related variables: alcoholism deaths, drunkenness arrests, cirrhosis deaths, and alcoholic psychosis figures. With the onset of Prohibition there was the initial period of steep decline after which all the time series data show a steady increase, consistent with earlier studies (Miron and Zwiebel 1991: 244–45). They further find that the reduction in alcohol consumption was due to the increased economic costs facing the consumer, and that any effects caused by the moral climate of condemnation or by respect for the law were negligible (Miron and Zwiebel 1991: 245–46). Their evidence lends support to the proposition that Prohibition increased the variance of quality and concentration and thereby increased the risks associated with alcohol consumption. Specifically, alcoholic deaths did not show the same post–initial response decline as the other variables even though per capita alcohol consumption (measured in terms of pure alcohol) dropped by about a third. Deaths caused by alcohol were much closer to their pre-Prohibition levels. This result suggests that prohibition increased the cost of estimating harm because of increases in concentration and quality variability, resulting in an increased death rate per gallon of pure alcohol consumed.

Per unit excise taxes, like prohibition, tend to cause a substitution toward "quality" goods, very often with higher concentrations of the "desired" active ingredients (see Barzel 1976). An excise tax on distilled

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spirits was the first internal tax passed by the government of the new United States, in March 1791. Because the tax per gallon on low-quality "Western" whiskey was the same as that on the higher-quality Eastern whisky, which before the tax commanded twice the price, the effect of the tax was to reduce the price of Eastern whisky relative to that distilled in the West.[5] This excise tax led to the Whisky Rebellion.

Returning to the cigarette issue: Per unit excise taxes on cigarettes lower the relative price of those with more nicotine and tar—the desired attributes of cigarettes—since they are taxed at the same rate as those with lower nicotine and tar. The set-point model suggests that consumers will adjust consumption to maintain the same set-point level of nicotine and possibly tar in their systems. The reduction in the relative price of high-nicotine and -tar cigarettes brought about by higher excise taxes coupled with set-point behavior should lead to the increased consumption of high-nicotine and -tar cigarettes relative to those with low levels of these substances. Evans and Farrelly (1998) examine the responses of smokers across states to different levels of excise taxes. Their variables include average total cigarette consumption, average cigarette length, and average tar and nicotine intake per day. Although they are not specifically testing the set-point hypothesis their evidence is consistent with that model. They found that "smokers in high-tax states are more likely to smoke cigarettes higher in tar and nicotine. Although taxes reduce the number of cigarettes consumed per day among remaining smokers, total daily tar and nicotine intake is unaffected. Young smokers . . . [are even] more responsive to changes in taxes. . .their total daily tar and nicotine intake actually increases after a tax hike" (Evans and Farrelly 1998: 1). Evans and Farrelly suggest that taxes should be based on tar and nicotine levels instead of simply on the unit of the pack (p. 23). Though this would tend to reduce tar and nicotine level per cigarette, set-point maintaining behaviors (including inhaling more deeply and smoking more of the now relatively inexpensive low nicotine and tar cigarettes) will tend to maintain constant nicotine and tar levels.

An additional problem with the ability of government to use taxes to regulate smoking is limited by the ease of smuggling cigarettes into high tax jurisdictions. Current estimates suggest "that about 280 billion of the 1 trillion cigarettes exported each year pass through the hands of smugglers" (Bonner and Drew 1997: C12). Price increases resulting from the potential legal settlements between the tobacco industry and various plaintiffs are predicted to be in the range of 62 cents per pack. When those increases are coupled with a possible federal tax

[5]The West at this period in time was Western Pennsylvania, Virginia, and North Carolina.

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increase of $1 or more and likely state tax increases, the overall price increase may be as much as $2 per pack. Increases of much less magnitude have resulted in a significant increase in smuggling worldwide. In Spain for example, "Winston is the most popular foreign brand, and last year 60 percent of its sales were contraband" (Bonner and Drew 1997: C12). Illegal Winstons sold for $1.30 to $1.60 per pack, approximately one third less than the legal price (Bonner and Drew 1997: C12). An additional concern is that teenage smokers, who are considerably more sensitive to increases in price than adults, are much more likely to switch to cheaper, lower-quality black market cigarettes with perhaps higher nicotine and tar content, and some will also substitute marijuana or other illegal substitutes.

Smugglers appear to be able to tap sources of production on a worldwide scale, and introduce their goods at low cost into any country where the government attempts to control access. This suggests that U.S. efforts to regulate tobacco consumption through a combination of litigation and excise taxes is bound to be less than successful and may result in the consumption of cigarettes with higher tar and nicotine levels, especially among teens.

A final problem with prohibition is that, by making an addictive substance illegal, it fosters behaviors that by themselves can be more harmful than the addiction itself. By driving the use of psychotropic substances "underground," behaviors that individuals would never otherwise engage in can become desirable by association. When activities such as needle sharing in hidden alleys and cruising for drug deals can become sought-after activities, when consumed in conjunction with the self-reinforcing substances, it is even more difficult to reduce or discontinue consumption of a given substance. These activities obviously can, by themselves, result in harm to the user by leading to consequences such as becoming a victim of crime and the transmission of hepatitis and AIDS.

Conclusion

An examination of the biology and economics of addiction suggests that government regulation of these substances can have significant adverse, unintended consequences. The association and set-point effects and various substitution effects can potentially result in increased harm over preregulation levels to the users of addictive substances. This, perhaps, still leaves a policy role for government: to simply provide information about the harmful effects of the various substances. We know that this approach has been successful, for

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example, in reducing adult smoking rates (Bartecchi, MacKenzie, and Schrier 1995: 44–51).

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Political Influence and the Internal Revenue Service

Jim F. Couch, Keith Atkinson, Tommie Singleton, and Pete M. Williams

> He has erected a multitude of New Offices, and sent hither swarms of Officers to harass our people, and eat out their substance.
>
> —Declaration of Independence

The Mendoza family was both surprised and alarmed when they received notice from the Internal Revenue Service (IRS) that their home would be confiscated if $200 in back taxes were not paid, especially in light of the fact that the family had never experienced any previous tax problems. However, it was Patricia Mendoza who was seen on television shouting insults at President Clinton about the deaths of 19 soldiers in Saudi Arabia: "You stink, and those boys died" (*Richmond Times-Dispatch* 1997). Critics of the Clinton administration are convinced, and perhaps for good reason, that the Mendoza's tax problems are not coincidental.

The Clinton administration has been questioned about its political usage of the IRS. For example, James Adams (1997) reports that, "tax authorities have launched a series of audits into many large organizations which have criticized the [Clinton] administration over the past four years." Groups targeted for audit include Citizens Against Government Waste, the Heritage Foundation, the National Rifle Association, the Freedom Alliance, and the Western Journalism Center. Two conservative magazines, *The National Review* and the *American Spectator*, are also under audit. On the other hand, left-leaning nonprofits and periodicals have escaped such scrutiny (Roeser 1997).

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The publicizing of data collected by the Transactional Records Access Clearinghouse (TRAC) at Syracuse University detailing the rate of returns audited by geographic region has only added to the growing mistrust of the IRS.[1] TRAC results indicate that large variations exist in the percentage of returns audited from a high of 2 percent of Nevada individual returns to only 0.3 percent of Kentucky returns. Examining audit rates by region, the TRAC data reveal an erratic pattern of IRS enforcement. The following questions therefore arise:

> Does it appear that the IRS has developed and pursued logical, effective and coherent enforcement strategies? Does it appear that, as required by the United States Constitution, similarly situated taxpayers are being treated in similar ways? Can the IRS managers . . . explain and defend their tax enforcement strategies? [TRAC 1995a.]

This paper investigates these issues and examines whether political considerations play a role in determining IRS enforcement patterns. A statistical analysis of the TRAC data reveals a systematic relation between the rate of tax audits and the percentage of voters casting a ballot for Clinton. It was also found that audit rates within a district are related to the district having congressional representation on a committee charged with IRS oversight.

The IRS: Its History and Responsibilities

The underpinnings of the IRS can be traced through a series of events in U.S. history. Under authority of the same 1791 law that established an excise tax on whiskey and led to the nation's first tax revolt, Treasury Secretary Alexander Hamilton created the Office of the Commissioner of Revenue—the predecessor of the modern IRS. The first federal income tax was passed as an emergency funding measure during the Civil War. The Office of the Commission of the Internal Revenue Service was established on July 1, 1862 (Bureau of Internal Revenue of the U.S. Treasury) and renamed the Internal Revenue Service in 1953. Its official mission is to collect the proper amount of tax revenue at the least cost to the public and in a manner that warrants the highest degree of public confidence in the IRS's integrity (U.S. Government Manual 1992–1993). Despite calls for the repeal of the income tax and criticism from an unlikely source, the IRS was here to stay. Writing to the U.S. House of Representatives

[1]The TRAC was established in 1989 to provide citizens with accurate information regarding the activities of federal agencies including the IRS.

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Committee on Ways and Means in 1871, the commissioner of the IRS stated that he considered the income tax as "the one of all others most obnoxious to the genius of our people, being inquisitorial in its nature, and dragging into public view an exposition of the most private pecuniary affairs of the citizen" (House Misc. Doc. No. 51, 41–3; see http://hellohanover:com/033197tax.html).

In 1894, Congress enacted an income tax law that was challenged in the federal courts. In *Pollock v. Farmers' Loan and Trust Company*, the Supreme Court found the law unconstitutional because it taxed real property without apportionment among the states according to population as required by Article 1, Section 8 of the Constitution.

The efforts for a federal graduated income tax by populists, progressives, and other reformers finally led Congress to submit to the states a constitutional amendment in 1909. On February 25, 1913, the 16th Amendment was ratified. It declared, "The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration." Congress assigned the responsibility of collecting income taxes to the IRS, and required income earners to file accurate and timely tax returns with the IRS. In that first year the rate of the federal income tax was 1 percent on income exceeding $3,000 for unmarried individuals and $4,000 for married filers. Today, a taxpayer may pay as much as 39.6 percent of earnings in the form of income taxes.

The IRS increased its ability to raise revenues during World War II. A law was passed requiring employers to withhold from salaries and wages the income taxes that were due the federal government. The wartime government desperately needed cash, but installment payments frequently left taxpayers with obligations that they could not meet. Withholding "meant that workers never even saw or held the money they earned before it was shipped off to Washington" (Davis 1997:196). After the war ended, President Truman held an informal meeting with congressional leaders to determine what to do about withholding. "The Congressmen quietly insisted that they wanted to keep the money coming in for a while" (Davis 1997:197). They wanted to build roads and bridges, schools and hospitals and "we want our names on them" (Davis 1997:197).

The income tax can represent significant costs to taxpayers in multiple forms. First, taxpayers not only are subject to paying high taxes, but they may pay a lot more. When the IRS determines that additional taxes are due, taxpayers are usually required to pay a penalty plus interest on the taxes owed. If the agency suspects that the taxpayer has knowingly evaded taxes, the IRS can even recommend that the

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individual be charged with a criminal violation. Second, in addition to the $7.2 billion needed to operate the IRS, at least $225 billion (that is $850 for every man, woman, and child in America) must be added to account for the cost of complying with the tax code (http://www.fairtax.org/the_case/index.html)—and those dollars come from taxpayers.

As tax rates increased over the years, taxpayers eventually sought ways to avoid some or all of their income taxes. Over time, an underground economy evolved—that is, economic activities hidden from tax authorities through the under reporting of income, or the failure to report income. The size of this economy has been estimated to be as much as 10 percent of U.S. GDP (Marlow 1995: 458). The IRS seeks to lower such tax evasion through enforcement of the tax code.

Some observers point out that political considerations may influence enforcement activities such as audits. The blatant use of the IRS for political purposes is not new. During the Kennedy presidency, a mysterious IRS organization called "The Ideological Organizations Audit Project" was formed to investigate right-leaning groups; among those apparently targeted was Young Americans for Freedom (Davis 1997: 246). The Special Services Staff (SSS) was formed during the Nixon administration to coordinate "all IRS activities involving ideological, militant, subversive, radical, and similar type organizations" (Davis 1997: 88).

The Clinton Politicos, in their own report regarding the Travelgate Scandal (the firing of career travel office employees and their replacement with Clinton cronies), reveals that White House Associate Council William H. Kennedy III pressured the FBI to investigate the travel office and if "the FBI was unable to provide guidance, Mr. Kennedy might have to seek guidance from another agency, such as the IRS" (*Washington Times* 1997). Two days after the travel office workers were fired, three IRS agents visited UltrAir, the airline that handled most White House press travel.

Although accusations have been made that political considerations play a role in who is subjected to audits, IRS spokesperson Frank Keith insists, "agents are not susceptible to manipulation" (Scarborough 1997). Former IRS historian Shelley Davis, however, disagrees. "When you work for the IRS . . . you obey what your superiors at the IRS want you to do. That is the only way to climb the ladder to high level executive status" (Scarborough 1997). And a more politically minded commissioner could not have been found than Clinton appointee, Margaret Milner Richardson. Richardson, a close family friend and a self-described "yellow-dog" Democrat, worked on the 1992 Clinton campaign. Joseph Farah, director of the Western Journalism

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Center, explains, "If you wanted to politicize the IRS, she was a great choice" (Adams 1997).

But does the IRS apply its enforcement activities, such as audits, uniformly among taxpayers? Based on recent anecdotal evidence from congressional hearings, and numerous newspaper accounts, we hypothesize that such activities of the IRS tend to be influenced by politics.

Data and Empirical Results

The research data used to examine this hypothesis come from the TRAC. That database includes data from tax returns and IRS enforcement activities (TRAC 1995b). The data allow us to examine the audits of taxpayers by tax district (63 districts loosely associated with states).[2]

The results cause one to question what truly motivates audits. As Table 1 makes clear, the variations are large and somewhat puzzling. As David Burnham points out, "This kind of erratic enforcement increases cynicism of the public against their government" (*Times Daily* 1997).

Faced with this evidence, the IRS has tried to explain why their enforcement activities vary so widely between districts. One spokesperson suggested that audit rates are higher where the number of taxpayers that cheat are higher: "There are going to be some areas that have a higher noncompliance level" (*Times Daily* 1997). Along these same lines, Ted Brown, the head of the IRS criminal investigations units, adds, "One possible reason for the high number of audits could be the unusually large use of the earned income tax credit [EITC] in . . . relatively poor state[s]" (*Clarion-Ledger* 1997:1). The EITC is often abused and is apparently a so-called "red flag" in the decision to audit. IRS defenders also point out that the location of auditors accounts for a large portion of enforcement activity.

These explanations for enforcement patterns are subjected to empirical scrutiny and an OLS (ordinary least squares) model is used to test the influence of explanatory variables on audits (enforcement activities of the IRS). Taking each of the possible explanations of causation into effect (those offered by the IRS and those hypothesized by the authors), the following model was derived to determine what factors are correlated with the rate of tax returns audited across IRS districts:

[2]Except for a few of the more heavily populated states, IRS district boundaries and state boundaries are the same.

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TABLE 1

RANK ORDER, ODDS OF DISTRICT TAX AUDIT 1995
(PERCENT IS BASED ON INDIVIDUAL RETURNS FILED)

State (Tax District)	Percent Audits	State (Tax District)	Percent Audits
Nevada	2.0	Vermont	0.6
California (Laguna)	1.6	New Mexico	0.6
California (San Francisco)	1.4	South Dakota	0.6
California (Los Angeles)	1.3	Indiana	0.6
Mississippi	1.2	Delaware	0.6
Georgia	1.1	New York	0.6
Idaho	1.1	Minnesota	0.6
Alaska	1.1	Florida (Jacksonville)	0.6
New York (Manhattan)	1.1	North Carolina	0.6
California (Sacramento)	1.1	Illinois (Chicago)	0.6
Texas (Dallas)	1.0	Kansas	0.6
Rhode Island	1.0	Missouri	0.6
Arkansas	0.9	Nebraska	0.5
California (San Jose)	0.9	South Carolina	0.5
Wyoming	0.9	Tennessee	0.5
Louisiana	0.9	Iowa	0.5
North Dakota	0.9	Massachusetts	0.5
Colorado	0.9	Michigan	0.5
Oklahoma	0.8	New York (Buffalo)	0.5
Connecticut	0.8	West Virginia	0.5
Texas (Houston)	0.8	DC/Maryland	0.5
Alabama	0.7	Wisconsin	0.5
Texas (Austin)	0.7	Virginia	0.5
Utah	0.7	Pennsylvania (Philadelphia)	0.4
Arizona	0.7	Illinois (Springfield)	0.4
Florida (Ft. Lauderdale)	0.7	New York (Albany)	0.4
Montana	0.7	New Jersey	0.4
Hawaii	0.7	Pennsylvania (Pittsburgh)	0.4
Maine	0.7	Ohio (Cleveland)	0.3
Oregon	0.7	Ohio (Cincinnati)	0.3
New Hampshire	0.7	Kentucky	0.3
Washington	0.7		

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$$(1) \quad \text{Audit Rate} = A + b_1\,\text{POVERTY} + b_2\,\text{AGENTS} + b_3\,\text{GAMBLING} + b_4\,\text{SENATE} + b_5\,\text{HOUSE} + b_6\,\text{CLINTON} + e,$$

where POVERTY is the percentage of persons below the official poverty rate in 1993 and is entered to determine the influence of the EITC on the rate of audits. This variable is found in the *Almanac of the 50 States* (Hornor 1996). AGENTS is the 1995 per capita number of revenue agents in each district and is a part of the TRAC data (TRAC 1995b). It is expected that additional per capita agents will result in additional per capita audits within a particular district.

The decision to evade taxation can be mathematically modeled. Letting d represent the number of dollars underreported, c the probability of being caught, t the marginal income tax rate, and P the size of the penalty imposed, the optimal amount of evasion is given by the following:

$$(2) \quad td = cP(d),$$

and at the margin:

$$(3) \quad t = cP'.$$

Of course, individuals who are risk averse may wish to avoid such a gamble. Thus, more evaders are expected where a greater number of risk takers reside. To capture the influence of noncompliance, state gambling dollars from parimutual, lottery, casino and devices, bookmaking, card rooms, bingo, and charitable games are included in the model (*U.S. News & World Report* 1996: 57).[3]

Public choice theorists claim that the activities of government are guided, at least in part, by political considerations. CLINTON is included as an independent variable and represents the percentage of total votes within a state cast for Clinton in the 1992 presidential contest. If fewer audits per return were performed in states that gave greater political support to the administration, then the results would suggest that a reelection strategy helped to shape IRS enforcement activity. The variable is found in the *Statistical Abstract of the United States*, 1996.

A number of studies of the determinants of government expenditures have found that the relative power of a state's representatives in Congress plays a role in determining geographically where dollars are spent. The results of one such study suggested that even the

[3]This is admittedly a rough estimate because of cross-state participation in lotteries.

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number of soldiers per state put at risk during the Vietnam War was negatively related to the clout of the state's politicians (Goff and Tollison 1987). Thus, it is not unlikely that IRS administrators would be sensitive to congressional power and, in particular, be hesitant to annoy those citizens whose representatives are charged with IRS oversight. Both of the independent variables, SENATE and HOUSE, are entered in this regard.

SENATE is a dummy variable equal to one if the states' senator is a member of the Senate Taxation and IRS Oversight Committee and zero otherwise. HOUSE is likewise a dummy equal to one if the representative within one of the 63 IRS districts was a member of the House Ways and Means Committee, the committee charged with IRS oversight, and zero otherwise. (Committee membership was found in *Congressional Quarterly* 1996.)

The results are presented in Table 2. The model explains nearly 50 percent of the variation of the dependent variable. The variables POVERTY, GAMBLING, and AGENTS are all positive and significant and thus behave as IRS defenders predicted. More agents in a district result in more audits, and the EITC along with gambling dollars attracts the attention of the IRS. Interestingly, our results suggest that gambling activity may serve as a proxy for risk-taking behavior—the kind of behavior exhibited by tax evaders.

The political variables offer explanatory power as well. SENATE was negative and significant at the 10 percent level, indicating that citizens residing in those states whose senators were members of the IRS oversight committee were subjected to fewer audits. Likewise, taxpayers in districts with representatives on the powerful Ways and Means Committee experienced significantly fewer audits. In addition, the variable CLINTON was negative and significant at the 10 percent level of confidence, indicating that greater political support in a state resulted in a lower rate of returns audited. In fact, an increase of 10 percent in the 1992 presidential vote for Clinton led to a 0.1 percent reduction in audits.[4]

Finally, a second equation was used to test for the presence of an endogenous variable—specifically AGENTS. A two-stage least squares model was estimated (see Table 2). During the first stage, the number of agents assigned during President Bush's last term served as an instrumental variable. The findings were similar to those in the simple OLS model above.

[4]Only the explanatory variables CLINTON and POVERTY were significantly correlated at the 5 percent level of confidence with the correlation coefficient equal to 0.27.

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TABLE 2

ACCOUNTING FOR IRS AUDIT ACTIVITY

Independent Variables	Dependent Variable: Percentage of Individual Returns Audited	
	OLS Results	TSLS Results
AGENTS	0.006 (4.99)***	—
GAMBLING	0.000006 (5.14)***	0.000006 (5.06)***
POVERTY	0.023 (2.86)***	0.023 (2.79)***
SENATE	-0.13 (1.79)*	-0.129 (1.75)*
HOUSE	-0.14 (2.09)**	-0.134 (2.04)**
CLINTON	-0.01 (1.87)*	-0.01 (1.83)*
PREDICTED AGENTS	—	0.006 (4.76)***
CONSTANT	0.513 (2.18)**	0.26 (0.97)
R^2	49.9	48.4
F-Statistic	9.12 (0.000)	8.6 (0.000)
Number of Observations	63	63

NOTE: t-statistics in parentheses below estimated coefficients; * indicates coefficient is statistically significant at the 90 percent confidence level; ** indicates coefficient is statistically significant at the 95 percent confidence level; *** indicates coefficient is statistically significant at the 99 percent confidence level.

Our results suggest that political factors play a role in determining whether taxpayers in a particular state or region are subjected to audit.

Conclusion

While history is replete with anecdotal evidence concerning the misuse of the Internal Revenue Service, this paper attempts to offer, to our knowledge, the first empirical evidence of systematic political manipulation. Findings reveal that the IRS is more active in states

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where noncompliance is more likely, but we also find evidence that political factors help shape enforcement patterns. For example, the IRS audits fewer returns in states whose representatives are members of congressional committees charged with IRS oversight. In addition, taxpayers in those states that gave Clinton greater political support were subjected to significantly fewer audits. Using 1995 audit rate data from the 63 IRS districts across the nation, we find that political factors offer significant explanatory power. In particular, a 10 percent increase in the vote for Clinton in the 1992 presidential election led to a 0.1 percent reduction in returns audited from the state. Thus evidence supports our hypothesis that both public-interest and private-interest motives shape IRS enforcement activity.

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Women's Athletics and the Elimination of Men's Sports Programs: A Reevaluation

Dennis K. McBride, Laura L. Worcester, and Stephanie L. Tennyson

Don Sabo (1998) distributed surveys to 902 colleges and universities in order to assess the impact on so-called gender equity that may have been imparted by the implementation of Title IX of the Education Amendment of 1972. (The term *gender* is used increasingly but nonetheless colloquially, even in the scientific literature, to mean *sex*.) The purpose of Title IX (20 U.S.C. §§1681–88), of course, was to equalize opportunities between the sexes for participation in collegiate athletics, in effect, by requiring member schools to proportionalize the quantity of offerings for men and women against enrollments. Sabo (1998: 27) cites political columnist George Will as representative of a doubtful perspective on the outcomes of the legislation: "Title IX is having the perverse effect of destroying opportunities for men" (Will 1997). Sabo's conclusion, based on his inspection of 637 questionnaires, was that "the evidence does not support the contention that the growth of women's opportunities in college athletics was accompanied by the widespread elimination of men's sports" (p. 30). Simple inspection and reexamination of Sabo's data suggest otherwise.

Analysis of Survey Results

Sabo's tabularized results are summarized in Table 1. The data indicate that, for the 19 years represented (and assuming that the 71 percent net yield of survey returns was representative of the national trend), women's programs increased across all NCAA divisions com-

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TABLE 1

NET OUTCOMES OF WOMEN'S AND MEN'S SPORTS PROGRAMS (1978–96)

NCAA Division	Number of Sports Added		Number of Sports Eliminated Sabo's Data		Net Change	
	Men	Women	Men	Women	Men	Women
I	183	679	298	208	−115	471
II	344	653	286	201	58	452
III	400	907	269	172	131	735
Totals	927	2,239	853	581	74	1,658

SOURCE: Sabo (1998).

bined, by 1,658. Men's programs increased by 74. Thus, women's programs grew at a rate of approximately 87 per year; men's grew at a rate of less than four per year—or about one per division per year. Assuming that men's program growth is not statistically equivalent to zero, female sports programs grew more than 22 times faster than did men's. For Division I schools, women's programs increased by 471, men's *decreased* by 115. Combining the trends of male and female program changes, the national change was 1,732 in net program growth. Thus women's programs grew at a rate that is almost an order of magnitude greater than the combined (male and female) national trend.

Sabo concluded that men's athletic participation did not decline, based presumably on the observation that there was a net increase of 74 programs. There are at least three problems with this hasty (we contend) conclusion: (1) the inference assumes no background growth expectation for men's programs; (2) it ignores the fact that Divisions I, II, and III are not at all alike in enrollment; and (3) the analysis implicitly trusts the validity of a 71 percent survey sample. These three issues are addressed in turn.

Background Growth Rate

First, consider the background growth rate. As in all market environments, from biology to business, there is a natural dynamic of extinction and speciation—in this case, in the demand and supply of sports programs. Moreover, in public policy matters, there is a commonly ratified assumption of *base* or *baseline* of service that is intentionally wed to the size of the population served (see Schick 1995: 12–31;

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Wildavsky 1979). Thus, when the quantity of service provided grows in proportion to demand (e.g., with quantity of population), the net is considered to be nongrowth. An increase of service at a rate less than population growth is referred to as program *reduction*. It is very reasonable that for NCAA sports, absent Title IX, there may well have been substantial and successful pressures to increase men's offerings, particularly in light of the approximately 25 percent increase in enrollment that occurred between 1978 and 1996 among American colleges and universities (see Funk and McBride, forthcoming). In fact, although offset by eliminations, over 900 new men's programs were added nationally during the nearly two decades covered by Sabo's data. This confirms that a nonnegligible background dynamic existed for male programs, and therefore, that a zero-growth expectation was not obvious. Sabo should have compared the net increase of 74 men's programs that obtained during the Title IX regime against a baseline (or potential growth) expectation generated by market demand without Title IX (e.g., mean net growth from pre-Title IX eras). In other words, Sabo's assumption (or implicit null hypothesis) of a static market is flawed. An appropriate comparison cannot be adduced from Sabo's data.

Per Capita versus Aggregated Impact

The second issue is that the simple tabulation provided by Sabo ignores student body (enrollment size) differences among Division I, II, and III schools, and thus it ignores the impact on per capita athletic *opportunity*. This fallacy of aggregation obscures the real net effect of Title IX per student. Current NCAA enrollments (as of January 1999) are listed in Table 2. As is evident, Division I schools enroll over a million more students nationally than do Divisions II and III combined.

Based on these figures, the total number of students impacted by Title IX per year were approximately 2.7 million (Division I), 0.9 million (Division II), and 0.6 million (Division III). These sums (each divided by 1 million for convenience) were normalized with Division III as the baseline (i.e., each multiplied by .64) to weight the totals reported by Sabo (from Table 1). This provides an assessment of per capita opportunity to participate in sports—a statistic that is more meaningful than coarsely resolved program totals per division. The rightmost column in Table 2 reflects net normalized opportunity for each NCAA division, adjusted by the corresponding coefficients in the adjacent column. Specifically, these entries modify Sabo's Table 1 column entitled, "Net Change for Men," by factors of 5.6

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TABLE 2

NCAA ENROLLMENTS AS OF JANUARY 1999 AND NET ATHLETIC OPPORTUNITY

NCAA Division	Number Members	Total Enrollment	Mean Enrollment	Enrollment Coefficient	Adjusted Opportunity
I	308	2,678,619	8,697	5.6	−644
II	281	877,835	3,124	2.0	116
III	397	617,293	1,555	1.0	131
Totals or Net	986	4,173,747			−397

SOURCE: DeJulio (1999).

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(e.g., $5.6 \times -115 = -644$), 2, and 1 for Divisions I, II, and III, respectively. As is obvious, the normalized, net opportunity for the more than one million men enrolled in Division I, just as Sabo reported for net offerings, decreased substantially. More conclusively, for all three divisions combined, net opportunity declined for men by nearly 400 program equivalents. Clearly, program opportunity per male student substantially decreased nationwide.

Survey Validity

The third issue is that of the validity of the 71 percent survey yield. Sabo (1998: 28) reported that 767 of the 902 solicitations (or 85 percent) were returned and that of the 767 solicitations, 637 (or 83 percent) were used for analysis. He did not indicate the rationale for disregarding 130 of the returned surveys. Regardless of the reason, the reader might well assume that the immediately provided analysis that "unearthed several patterns" (p. 28) was based on an 83 percent return rate. This is, of course, false. The net yield was actually .85 (returned) $\times$ .83 (analyzed) = 71 percent. (Sabo's 637 schools represent 65 per cent of 1998 NCAA membership.) That approximately 300 schools were not represented does not by itself invalidate Sabo's findings. In fact, a 100 percent return rate might well have strengthened his conclusion. But readers should understand that Sabo's inferences are based on reports from 71 percent, and not 85 or 83 percent of NCAA schools solicited, and that the complementary 29 percent might have significantly altered his findings.

More Penetrating Analysis

An inspection of the NCAA's programs during the 1997–98 academic year provides a further and more penetrating analysis of today's putative equality of current, mandated sports offerings (see NCAA 1998). As the entries in Table 3 suggest, female offerings outnumber male offerings for sports that are listed as offered to both sexes. (Baseball, football, water polo, ice hockey, and wrestling are anachronistically listed as offered only to men, to which we will return below; field hockey, rowing, and softball are listed as offered only to women.) For example, more Division I schools offer basketball to men (308) than to women (302); more Division I schools offer swimming to women (170) than to men (151). Of the 40 sports specifically offered to both sexes, there are 31 in which there are more college programs for females and only 9 for which the opposite is true. This polarity is statistically significant ($\chi^2_{(1)} = 10.6, p < .001$). The same trend holds within divisions: For Division I, (12) female programs surpass (2)

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TABLE 3

NUMBER OF SCHOOLS DURING 1997–98 THAT PARTICIPATED IN NCAA SPORTS

	Men's				Women's			
Sport	I	II	III	Total	I	II	III	Total
Baseball	276	224	320	820	—	—	—	—
Basketball	*308*	*279*	356	943	302	273	*386*	961
Cross Country	294	212	292	798	*304*	*234*	*312*	*850*
Fencing	19	2	14	35	*24*	1	*17*	*42*
Field Hockey	—	—	—	—	72	26	135	233
Football	231	152	217	600	—	—	—	—
Golf	*276*	*171*	*224*	*671*	169	55	86	310
Gymnastics	24	1	2	27	*68*	*7*	*16*	*91*
Ice Hockey	52	13	63	128	—	—	—	—
Lacrosse	52	*31*	105	188	*59*	22	*118*	*199*
Rifle	5	0	*3*	8	*9*	0	1	*10*
Rowing	—	—	—	—	63	14	35	112
Skiing	11	7	20	38	*13*	*8*	*21*	*42*
Soccer	191	*160*	335	686	229	153	339	*721*
Softball	—	—	—	—	226	228	325	779
Swimming	151	51	169	371	*170*	*66*	*206*	*442*
Tennis	273	192	305	770	*296*	*220*	*343*	*859*
Indoor Track	238	98	179	515	*254*	99	*187*	*540*
Outdoor Track	259	138	229	626	*269*	138	*243*	*650*
Volleyball	22	14	32	68	*294*	*258*	*368*	*920*
Water Polo	25	5	14	44	—	—	—	—
Wrestling	95	46	105	246	—	—	—	—
Totals	2,802	1,796	2,984	7,582	*2,821*	*1,802*	*3,138*	*7,761*

NOTE: For comparisons between the sexes, note that the entry with more offerings is *italicized* per NCAA Division (e.g., *308* > 302 for Division I basketball).
SOURCE: NCAA (1998).

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male programs ($\chi^2_{(1)} = 7.14$, $p < .01$); for Division II, (7) female offerings outnumber (5) male programs ($\chi^2_{(1)} < 1$); and for Division III, (12) female programs exceed (2) male programs ($\chi^2_{(1)} = 7.14, p < .01$). (Note: Application of the inferential statistical test assumes, of course, that the data are a sample and not the population itself.) Golf is the only program for which there are more offerings for men in each division and in total.

Currently, there are 17 (qualitatively) different sports offered for women, 19 for men. Although in fact already extant nationally, but not included in its table yet, the NCAA (1998) lists a category of *emerging* programs for women (archery, badminton, bowling, ice hockey, squash, synchronized swimming, team handball, and water polo) which (mutatis mutandis) adjusts net category offerings to 25 for women, i.e., 32 percent more than for men.

Conclusion

One view of Title IX and its ambitions is that any public policy that aims to equalize access to resources or to manufacture equal outcomes is, ipso facto, fair. But it should be noted that political ambitions as embodied in public law, like Title IX, and their implementation consequences are not necessarily nor even reliably identical. Succinctly, there are often unintended consequences of well-intended law. Although Title IX requires equal *offerings* per school, its ambition was to provide equal *opportunity*—that is, to eliminate sex discrimination. Regardless of the true desideratum of Title IX—equal offerings, equal opportunity, or equal outcomes between the sexes—the law seems to be based on a faulty criterion. That is, it embraces as valid an abstruse standard by which colleges and universities should measure the *educational* value of male and female participation in competitive athletics: arithmetic parity between men's and women's sports offerings. Title IX's consequence is fallaciously measured by tallying its mechanisms.

Although Title IX was not the product of malevolence toward men, the consequence of its two-decade regime is nonetheless objectively clear: Men's access to sports programs realized *a net decrease*. In fact, in terms of current program offerings and per capita opportunity, the male-female valence has depolarized. In the aggregate, schools may now be out of compliance in reverse, although fair baselining should reflect that there are more women than men enrolled in higher education institutions today.

Proxy variables, like total programs offered, net real opportunity, and summary category offerings are not the only meaningful or exclu-

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sively appropriate measures of Title IX consequence—in fact, these are only leading indicators. Sabo's analysis and our own may both have missed the real point. Actual participation—a concurrent indicator—may be more reflective of Title IX's most meaningful impact. Kocher (1998) reported that for every female added to athletic rosters nationally, four males have been dropped, and that this represents a 10 percent (or 20,000) net reduction in male participation nationally.

Women have been summarily enfranchised by Title IX, and this is a well-intended and positive outcome. The policy that successfully increased female participation was a supply-side ministration applied, however, to approximately half of its stake-holding constituency. This was necessitated by the zero-sum implications of Title IX and simple economics. We do not claim that Sabo has ratified the decidedly normative remarks of his fellow sociologist H. H. Fairchild, who claimed: "All social science writings . . . involve certain ideological biases or political agendas. . . . Social science has the mandate of applying its *theories* and methods to alleviate human suffering and inequality" (Fairchild 1991: 112, emphasis added). But the record should be stated correctly: Sabo's conclusion is invalid. Men have been disenfranchised—we contend, from a disregard of demand. Don Sabo's data compellingly confirm George Will's (1997) simple assertion that the growth of women's programs was accompanied by a diminution of opportunity for men.

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BOOK REVIEWS

The Cost of Rights: Why Liberty Depends on Taxes
Stephen Holmes and Cass R. Sunstein
New York: W. W. Norton & Co., 1999, 255 pp.

The Cost of Rights is the work of two leading left-liberal legal theorists who are determined to undermine and replace the entire structure of modern law, the very concept of individual rights, and the law-governed polity.

The Cost of Rights has a fairly clear goal, which is to eliminate even the possibility of making a conceptual distinction between "negative rights" to noninterference (e.g., the right not to be murdered or the right to free exercise of religion) and "positive rights" or "welfare rights" (e.g., the right to a subsidized education or to a house built at someone else's expense). Thus, they claim that "apparently nonwelfare rights are welfare rights too" (p. 219) and that "all legal rights are, or aspire to be, welfare rights" (p. 222). They describe their virtually complete rejection of the liberal enterprise in terms of "a kind of communitarian or collectivist theme, though with deep roots in the liberal political tradition" (p. 224). Collectivist it certainly is, but they fail to show any roots in the liberal tradition.

The first page of the book starts by identifying the traditional idea of rights with alleged libertarian "opposition to government," a sly move intended to make libertarian critics of statism seem obtuse, for, as Holmes and Sunstein note on the very next page, "individual rights and freedoms depend fundamentally on vigorous state action" (p. 14). More radically, "Statelessness spells rightslessness" (p. 19). But what Holmes and Sunstein intend by the phrase "depend fundamentally" is not that government is charged by citizens with the delegated powers necessary to defend rights and secure justice, but that government creates rights ex nihilo. The authors brush aside discussion of moral rights and consider only legal rights, i.e., those rights that a state will actually enforce, for "When they are not backed by legal force, by contrast, moral rights are toothless by definition. Unenforced moral rights are aspirations binding on conscience, not powers binding on officials" (p. 17). Having set aside moral rights, Holmes and Sunstein then borrow (without acknowledgment) the

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definition of rights associated with Joseph Raz, viz., that rights are interests of persons that are sufficiently weighty to generate duties on the part of others, to which they add a heavy dollop of legal positivism. Thus, for Holmes and Sunstein, "an interest qualifies as a right when an effective legal system treats it as such by using collective resources to defend it" (p. 17). The authors then breezily claim that "Under American law, rights are powers granted by the political community" (p. 17).

The invocation of "American law" is otiose, for the theory they advance applies to all exercises of political power; it is a conceptual claim and not one limited to any particular political history. Further, there is nothing specifically "American" about the thesis, for any identifiable "American" theory of government rests on the idea that the people, in order to secure certain ends ("these Rights," "establish Justice," "the common defence," "the general Welfare," "the Blessings of Liberty," etc.), delegate certain powers to government. The rights that are secured are not "granted" by the political community, for, as the Declaration of Independence states,

> all Men . . . are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty, and the Pursuit of Happiness—That to secure these Rights, Governments are instituted among Men, deriving their just Powers from the Consent of the Governed, that whenever any Form of Government becomes destructive of these Ends, it is the Right of the People to alter or to abolish it, and to institute new Government, laying its Foundation on such Principles, and organizing its Powers in such Form, as to them shall seem most likely to effect their Safety and Happiness.

If Holmes and Sunstein wish to argue against that thesis and on behalf of a radically positivist theory, they are welcome to do so, but asserting *en passant* that pure positivism is somehow a matter of "American law" is shifty and devious. (It is especially bizarre when you consider that they attack a number of Supreme Court decisions that contradict their thesis; what, then, do they mean by "American law"?)

Setting aside the claim that this is a matter of "American law," let's examine the case they advance for positivism, i.e., for the thesis that law and rights are posited or laid down rather than discovered or recognized. First, they claim that focusing only on legal rights, i.e., those rights that are actually enforced by a political authority with the power to secure compliance, "can be justified by an enhanced clarity of focus" (p. 21). That is the promise, but nowhere do they fulfill it. Instead, they produce an account of rights that is both incoherent and self-contradictory.

Holmes and Sunstein claim to ground their claims on a common sense observation: all choices have costs. That is a conceptual or analytical claim, for to choose X over Y is to give up Y, which (if it is the most highly valued alternative forgone) is defined as the cost of choosing X. I have no objection thus far. They proceed to note that the act of choosing to enforce a right, like all choices, has a cost, viz., the most highly valued opportunity forgone. Combining that insight with the claim that the only

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rights that are meaningful are those that are actually enforced, they conclude that since the enforcement of rights has costs, rights themselves have costs. Thus the subtitle to the book: "Why Liberty Depends on Taxes." All acts of enforcement have costs and require the mobilization of resources—police, judges, jailers, executioners, etc.—and are therefore positive claims on the expenditure of taxes (or other forms of compulsion; conscription would fill the bill as well as taxation) to secure those resources. The right not to be killed is thereby converted into the right to police protection, which entails the expenditure of resources and therefore choices among alternative uses of those resources. Thus, the allegedly "negative" right not to be killed is indistinguishable from the "positive" right to the expenditure of resources to hire or conscript police. Indeed, Holmes and Sunstein see no difference between expenditures on police departments and expenditures on fire departments, both of which "protect private property." The implication is that there is no difference between an arsonist and lightning, which tells us a lot about Holmes and Sunstein's theory of moral agency and their dismissal of moral rights as mere "aspirations." In an appendix toting up the "cost of rights," the complete list of items under "Protecting Property Rights" is: "Patent and trademark protection," "Disaster relief and insurance," "Federal emergency management," "Community disaster loans," "Management and protection of forests," "Real property activities," "Fund for rural America (agricultural support)," and "Records management connected with property."

According to Holmes and Sunstein, "Rights are costly because remedies are costly. Enforcement is expensive, especially uniform and fair enforcement; and legal rights are hollow to the extent that they remain unenforced. Formulated differently, almost every right implies a correlative duty, and duties are taken seriously only when dereliction is punished by the public power drawing on the public purse" (p. 43). Even "the right against being tortured by police officers and prison guards" (p. 44) is, contrary to traditional liberal thinking, not a negative right not to be harmed, but a positive right to have monitors hired by the state to supervise the police officers and prison guards: "A state that cannot arrange prompt visits to jails and prisons by taxpayer-salaried doctors, prepared to submit credible evidence at trial, cannot effectively protect the incarcerated against torture and beatings. All rights are costly because all rights presuppose taxpayer-funding of effective supervisory machinery for monitoring and enforcement" (p. 44).

This is the first striking example of the complete incoherence of their theory, for the theory of rights and obligations on which they base their theory generates an infinite regress. Holmes and Sunstein argue that I cannot have a right not to be tortured by the police unless the police have an obligation not to torture me, and the police can only have an obligation not to torture me if there are some taxpayer-funded persons (monitors) above the police who can punish them (since "duties are taken

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seriously only when dereliction is punished by the public power drawing on the public purse"). But to have a right not to be tortured I would have to have a right that the monitors exercise their power to punish the police for torturing me. Do I have that right? According to Holmes and Sunstein, I would have such a right only if the monitors had a duty to punish the police, and the monitors would have a duty to punish the police only if there were some taxpayer-funded persons above the monitors who could (and would) punish the monitors for failing to punish the police, and so on, ad infinitum. For there ever to be a right of any sort, by Holmes and Sunstein's own theory, there would have to be an infinite hierarchy of people threatening to punish those lower in the hierarchy. Since there is no infinite hierarchy, we are forced to conclude that Holmes and Sunstein have actually offered an impossibility theorem of rights in the logical form of *modus tollens*: If there are rights, then there must be an infinite hierarchy of power; there is not an infinite hierarchy of power; therefore there are no rights.

The theory of liberty that Holmes and Sunstein advance also leads to strange conclusions. Throughout the book, Holmes and Sunstein use the terms "rights" and "liberty" interchangeably (e.g., pp. 39, 46, 83, 93). Taking their definition of a right as an interest that "qualifies as a right when an effective legal system treats it as such by using collective resources to defend it" (p. 17), we are justified in deducing the following:

> If I have an interest in not taking habit-forming drugs,
> *and*
> If the state uses collective resources to stop me from taking drugs,
> *then*
> I have a right that the state use collective resources to stop me from taking drugs.

Let us stipulate that the state places me in prison in order to keep me from taking drugs (and let's set aside the fact that real states have failed to keep drugs out of prison). Since, according to Holmes and Sunstein, to have my rights enforced is to enjoy the protection of my liberty, by putting me into prison the state is making me free. Indeed, if the state were somehow to fail to imprison me, they would be violating my rights and making me unfree. (But then, if the right were not actually enforced by the state, it would be no right. Trying to follow the implications of Holmes and Sunstein's theory is like thinking out the implications of the elevation of evil to good by the members of "The Addams Family." Ultimately, the attempt collapses into incoherence.) Holmes and Sunstein have advanced a profoundly collectivist theory of liberty, without any identifiable connection to the liberal political tradition.

Finally, the theory Holmes and Sunstein advance collapses into contradiction by page 203 of the book, which contains the first consideration of "moral ideas" since the introduction, where moral rights were dismissed in order to achieve "an enhanced clarity of focus." After maintaining for 200 pages that rights are dependent upon power, which they defined as

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the power to impose punishment ("duties are taken seriously only when dereliction is punished by the public power drawing on the public purse"), they make the following startling admission: "The dependency of rights on power does not spell cynicism because power itself has various sources. It arises not from money or office or social status alone. It also comes from moral ideas capable of rallying organized social support" (p. 203). The example they give is the civil rights movement, which dragged the state into protecting the civil rights of African Americans. But if moral ideas count as a form of "power," then what is the justification for the dismissal of moral rights at the outset? Could we not say that a police officer should abstain from torturing me firstly because it is a wicked and immoral thing to do—because it is a violation of my right not to be tortured—and not *merely* because the officer fears being punished by his superiors, who, in turn, must fear being punished by their superiors? The theory of Holmes and Sunstein collapses into incoherence when they incorporate "moral ideas" into their definition of power, which was offered as an alternative to moral ideas in the first place. (This shiftiness also shows up when they shift from terms such as "creation" and "grant" to describe the origins of rights to "recognition" when discussing the rather more touchy subject of "religious liberty" [p. 182].)

Their theory not only implodes as a moral theory, but it is incoherent as a political theory as well. Holmes and Sunstein cannot decide whether government is a power separate from the people that bargains with them or is the representative of the people:

> For its part, the government is willing to refrain from imposing confiscatory tax rates, not only because of political incentives, but also because public officials understand that reliable long-term revenues will be augmented if citizens are encouraged to accumulate private wealth, keep honest books, and bank and invest their earnings inside the country, or at least within the purview and reach of the IRS [p. 195].

Here, government is a party separate from the citizenry that *bargains with* them. But:

> If supposedly impartial rights accrued solely to the advantage of the rich, the American government's vital claim to represent society as a whole, rather than being a tool of special interests, would not only be tarnished. It would crumble [p. 207].

Here, government *represents* society.

One should expect of theorists who trumpet their attachment to democracy some coherent statement of the relationship between government and society. Their theory is not only incoherent and contradictory on the level of rights theory, but it fails as a political theory, as well.

This work is the logical combination of the views of two intelligent men who are profoundly hostile to individual liberty and limited government. Sunstein has gained some notoriety for advancing a novel "expressive"

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theory of law, according to which law is not about the securing of justice or the conditions of social cooperation, but about "norm management." That is the theory that conservatives have advanced against eliminating sodomy laws; it is not necessarily that they want sodomy laws to be uniformly enforced, you see, but repealing them would send the "wrong message" about "society's" estimation of homosexuality. The theory is profoundly anti-liberal. Holmes, in an earlier book, *Passions and Constraint: On the Theory of Liberal Democracy* (1995), had advanced the historically implausible thesis that the American founding was purely an act of "positive constitutionalism," with the emphasis on enabling the state to provide collective goods for the people and little or no concern with limiting the power of the state to do evil (which Holmes terms "negative constitutionalism"). That runs into some difficulty when we consider the language of the founding documents, not to mention the Kentucky Resolutions, in which Jefferson wrote that "confidence is everywhere the parent of despotism—free government is founded in jealousy, and not in confidence; it is jealousy and not confidence which prescribes limited constitutions, to bind down those whom we are obliged to trust with power: that our Constitution has accordingly fixed the limits to which, and no further, our confidence may go." (Holmes even misstates Locke's theory of property as "a monopoly granted and guaranteed by government for the sake of the public interest" [p. 254]; compare Locke's Second Treatise, §27, along with many other passages.)

It should not go unremarked that *The Cost of Rights* is extraordinarily polemical, unscholarly, and nasty in its criticisms of those with differing views. For example, immediately after gallantly conceding that "Many critics of the regulatory-welfare state are in perfectly good faith" (p. 216) they turn around to tar all critics of the welfare state with the charge of racism: "But their claim that 'positive rights' are somehow un-American and should be replaced by a policy of nonintervention is so implausible on its face that we may well wonder why it persists. What explains the survival of such a grievously inadequate way of thinking? There are many possible answers, but inherited biases—including racial prejudice, conscious and unconscious—probably play a role. Indeed, the claim that the only real liberties are the rights of property and contract can sometimes verge on a form of white separatism: prison-building should supplant Head Start. Withdrawal into gated communities should replace a politics of inclusion" (p. 216). The charge is not only unsubstantiated, it is beneath contempt. Still, despite their slithery style of argument, Holmes and Sunstein have advanced a thesis deserving of a rebuttal that does not sink to the level of its advocates. I hope that I have succeeded.

Holmes and Sunstein have produced a statement of collectivism clothed largely in liberal language. But a sheep's coat does not a sheep make.

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Post-Socialist Political Economy: Selected Essays
James M. Buchanan
Northhampton, Mass.: Edward Elgar, 1997, 285 pp.

The art of political economy has been a dying art for most of the 20th century. Since mid-century, political economy has made a comeback and that comeback was largely due to James Buchanan. Buchanan's work has made scholars pay attention to the rules of the game within which markets are embedded. He has also constantly pointed out that political economy reform must always begin in the "here and now" and not in whatever arbitrary start-state we imagine. Real world reform is constrained, to this extent, by where we start from. It is that point of departure which defines the problem that must be addressed by the political economist.

Post-Socialist Political Economy collects a variety of papers Buchanan wrote in response to the events of 1989–91, or influenced by those events. The essays emphasize the themes of how rules of the game within which we play structure the incentives that guide our actions and the flow of information that we must process in making our choices. In essence, this reiterates Buchanan's work on the "constitution of economic life" that sets the rules within which economic outcomes continually emerge. Deliberate choice can only be made at the level of rules, not among these outcomes. Thus, Buchanan's work bounds the pattern of outcomes, but cannot provide detailed predictions of outcomes.

The new wrinkle to these essays is Buchanan's consideration of the issue of legitimacy of the rules as conveyed in the asymmetric lived experience among people of the West and the East. The work of public choice and market process scholars has highlighted the incentive and informational difficulties associated with alternative institutional environments, but Buchanan peers beneath given institutions and explores the legitimacy accorded to those institutions by different people. The basic institutions of a Western market society, for example, do not accord well with the lived experience of the Soviet peoples with markets. The institutions of pricing and bargaining existed in both Soviet and post-Soviet periods. But under the Soviet period, the experience was one within the following situation: a black market without well-defined or enforced property rights, and a shortage of goods and lack of alternative supply networks.

Those who could exploit the shortage situation could capture "rents" in the form of monetary "bribes," "black-market profits," and nonmonetary "privileges." Markets were necessary for daily survival, but black (and other colored) markets are not the same as aboveground and legitimated markets backed by the rule of law despite the formal similarity of prices and bargaining. The asymmetry between "markets" has to be the starting point of thinking about transition.

Fixing this situation is not just a matter of freeing prices so they can adjust to the market-clearing level. Of course, freeing prices is a necessary

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move, but it is not sufficient. "Getting prices right" is not enough. What is required is an intricate mix of institutions that enable individuals to realize the gains from exchange, but the intricate mix of institutions must be legitimated in the belief structures of the people—we cannot just impose whatever institutional structure we want wherever we want to, it has to be "grounded."

Buchanan's book is an optimistic book about man's ability to design rules of the game to improve the everyday life of people tempered by a realist's appreciation of the difficulty of designing rules that can "stick." The future is ours to make, Buchanan insists, but with that call comes a huge moral responsibility that we must take seriously. In the end, *Post-Socialist Political Economy* is not a call for action as much as an invitation to study and think about profound issues. As such Buchanan provides the reader with an anti-utopian, and nonhubris, track for the political economy of transition. He lays out the unique role of economics as a public science—with special emphasis on the spontaneous ordering of market activities within a system of property, contract, and consent, and how deviations from that system are counterproductive. Economics as a public science, Buchanan reminds us, provides citizens with knowledge that empowers them to become informed participants within the democratic process.

The book ends with three chapters dealing with the idea of federalism and its relevance for the modern world. In so doing, Buchanan underscores his basic thesis—the need to establish constraints on the natural proclivities of men for shortsightedness and free-riding so that citizens can realize the generalized benefits of a market economy.

Buchanan's book contains much wisdom that is lacking from most (if not all) the emerging literature on the problems of post-socialist political economy in East and Central Europe and the former Soviet Union. Many of those books have a lot of details on the situation, or clever technical arguments, but little in terms of a moral narrative on political economy.

A few years ago I reviewed Joseph Stiglitz's book *Whither Socialism?* and started the review by pointing out that when you take a premier economic theorist and combine that with a premier economic problem you have very high expectations indeed. Buchanan's book raises our expectations in a similar way, but whereas Stiglitz fails to meet the challenge, in my assessment, Buchanan succeeds in putting questions in front of us that we must answer if we hope to move forward and address the difficulties associated with post-socialist political economy. Those questions deal with

(1) the *de facto* property rights arrangement that existed under the old system,
(2) the *institutional arrangements* within which markets are to be embedded after the reforms, and
(3) the *historical experience* and *cultural legacy* of the country under examination, and specifically the question of the lived experience with market institutions as a carrier of legitimacy.

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If we do not pay attention to those issues, we risk continual frustration due to misspecification of the problems and poor design of transition policies.

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Against Politics: On Government, Anarchy, and Order
Anthony de Jasay
London: Routledge, 1997, 245 pp.

For the first time the political philosophy of libertarianism and classical liberalism has gotten a solid base in logic and epistemology. To many Jasay's book will be a revelation (as James Buchanan remarked about Jasay's first book, *The State*). It would be impudent to attempt to give an exposition of the contents of this rich and tightly argued book. Thus I will try to give the flavor of it in order to whet your appetite for reading it.

Against Politics is a collection of articles published between 1989 and 1996 around a common theme: the political philosophy of government and "ordered anarchy." The essays fit together as chapters of an integrated work. The synoptic Introduction (pp. 1–7) concisely summarizes the contents. Part I convincingly criticizes statism, including the minimalist variety, while Part II proffers Jasay's own politico-economic theories. "Before Resorting to Politics" (Chapter 8) and "Conventions: Some Thoughts on the Economics of Ordered Anarchy" (Chapter 9) form the center of the book. Jasay incorporates many of the insights of Austrian economics and its successors in the United States, while eschewing the Misesian apriorism in epistemology (which in the opinion of this reviewer is untenable [Radnitzky 1995]). The work has a solid basis in epistemology and semantics, and its logic is impeccable.

Man's knowing capacity is seen in accord with Critical Rationalism. While recognizing that intellectual progress is nonetheless possible, the emphasis is on fallibilism, stressing that decisions have to be made under uncertainty and with a limited knowledge base, and taking into account that social actions also have unintended consequences. Only individuals can act (ontological individualism). Man strives to better his lot and makes at least implicitly cost-benefit assays whenever he deliberates; he reacts to a changing physical and social environment and a changing knowledge base.

In epistemology a clear distinction is made between statements (sentences with a descriptive function and, hence, with truth value) and judgments. Consequently Jasay's metaethics is noncognitivist: a sentence formulating a genuine value judgment ("value judgment," for short) has no truth value, since it has no empirical content of information. ("Truth" is defined in terms of the correspondence between the content of information of a descriptive sentence to facts.) A genuine value judgment can only have "validity" relative to a particular value system or system of

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norms. It is logically impossible to deduce a value judgment or norm from a set of descriptive sentences.

In ethics, Jasay voices a strong preference for the ideal of the free society, the presumption of liberty, property, and innocence (pp. 158–71). However, in contrast to libertarians such as Ludwig von Mises, Murray Rothbard, and Hans Hoppe, he provides a legitimating argument in favor of freedom, property, and innocence in terms of logic.

Typically, social action occurs either in the context of a voluntary social order or in a coercive order. The prototype of a voluntary order is exchange, the market; the choice example of a coercive order is the state. The state is the last (highest) instance of power, against which there is no appeal to another instance. It is a territorial monopolist in violence, and it declares its violence to be "legitimate." The absence of voluntariness is not a defining characteristic. The state would be the state even if the social contract were a tenable theory. (In Chapter 1 Jasay shows that this is not the case.) The market is based on individual choice, whereas politics by definition is based on collective decisionmaking. "Collective decision" is short for nonunanimous decision. The expression "politics" signifies such decisions. Jasay puts forth the thesis: "All nonunanimous politics—and unanimous politics would of course be redundant, and an oxymoron—is redistributive" (p. 3). Only a minor part of redistribution is explicit transfers. Subsidies and other protective measures such as regulations and various privileges have redistributive consequences. Material and financial values, positions, privileges, and prestige are also redistributed. That politics is redistributive is particularly clear when the democratic method of decisionmaking is being used. "If much of this [contractarian] reasoning is baseless, and the state is simply an enforcing mechanism to enable a winning coalition to exploit the residual losing coalition without recourse to violence, the delusions of necessity and convenience are of course an aid to the efficiency of the process" (p. 2).

In politics some decide for all, i.e., some override the preferences of others and dispose of the resources of others. Even the domain (what kind of alternatives there are), the borders between the realm of the collective versus the private, and by what metarules (rules for rulemaking, the constitution) are decided by collective choice. That mechanism is claimed to serve some putative "Common Good," a highly problematic concept (p. 69 f.), if only because what the "Common Good" is is also chosen collectively. However, "No basic institution chosen collectively can be, and remain, intrinsically better than collective choice, 'the Thing itself'" (p. 3). State coercion is used to impose the will of some on all, including on those who would reject it if they could. That is the moral problem of politics, any politics.

Jasay's target is not the content of politics (favoring Peter over Paul), nor its method (democratic or otherwise); it is not that politics is dishonest or corrupt, or that power is abused, or that perverse results are produced. Those things divert suspicion from the "Thing itself." Politics as such is the target of the book.

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The customary "liberal" arguments for the state are decisively debunked. The Hobbesian "Prisoners' Dilemma" expresses the problem of private contractors in the "state of nature": how to make contracts enforceable and thus credible. Jasay presents a knockdown argument against contractarianism: If contracts would require an enforcer—and according to contractarian theory a "last" enforcer can be created only by a social contract—then that contract too would need an enforcer, and so ad infinitum (p. 5). Contractarian arguments simply assume away the principal-agent problem (p. 19). There is no contractual exit from the state of nature (p. 22). "Non-rejectability" arguments involve either an infinite regress or circular reasoning.

Likewise "minarchist" arguments and constitutionalism are destroyed. They put forth a false problem: to find rules such that they create incentives for politicians to stick to the mandate of the "social contract." They falsely assume that constitutional politics differs radically from ordinary politics. The real problem is not to design a constitution of liberty, but "to find the conditions . . . under which [a constitution of liberty] would be likely to be adopted, respected, and left intact for long enough to do any good" (p. 53). The constitution is but a chastity belt whose keys are always within reach (p. 3). "States are an imposition, sometimes useful, sometimes a millstone, always costly, never legitimate, and never a necessity for binding agreements" (p. 36). The problem of collective action has not been solved. Hence, we should examine alternatives. The guiding maxim is that, if politics at all, then make the domain of politics as small as possible. Let us examine ordered anarchy and self-enforcing voluntary social orders.

The repeated games approach to anarchy is promising: institutions that support cooperation are seen as equilibria (conventions, norms, laws), and second-order orders supporting a first order evolve spontaneously. People expect to have long (and prosperous) relationships with the same groups of people. Reputation is offered to guarantee future behavior. Organized methods to economize the costs of gathering information and voluntary social orders arise. Medieval Europe's "Law Merchant," offshore banking, and private arbitration courts are based on self-enforcing, relational contracts and exemplify equilibria institutions. In other words, a set of rules is obeyed because everyone finds it in his interest to obey it.

The key ideas of "strict" (Jasay 1991) liberalism, freedom, and property are conceptually inseparable, because freedom, property, and individuality cannot be conceived as unrelated entities. Thus they are intertwined in their empirical exemplification.

In the literature, legitimizing arguments for positions in political philosophy usually make recourse to some natural-law doctrine. To John Locke the theistic version of the doctrine was available. Today "ultimate legitimizers" (God, Mother Nature, or some holistic, fictitious entity like "Society" or "the People") have lost their authority, at least for serious thinkers.

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Upon a closer look, Rothbard's ostensibly natural-law arguments for the central tenets of libertarianism turn out to be pragmatic: the right to self-ownership helps man to realize his vital interests.

Within the wing of property-right anarchists, prominent thinkers such as Mises and Rothbard adopt and adapt ideas of a modern branch of German idealism, of "justificationist philosophy" (*Begründungsphilosophie*). They legitimize the central tenets of their philosophy by "praxeology," a theory of action, which is conceived as *a priori valid*, because it is deducible from the "logical structure of the human mind." Mises uses Immanuel Kant's doctrine of the Synthetic Apriori, of propositions which assert something about reality, and the truth of which is known a priori, i.e., independent of experience (e.g., Mises 1978 [1962]: 42). Critical rationalists emphasize that man possesses many genetic aprioris, but rightly reject the idea of a descriptive sentence with respect to which truth claims are independent of empirical testing, independent of the test of experience.

Hayek, as a typical classical liberal, was ambivalent: he wanted to accord to freedom and property final value (he called them "taboos"), but he thought that it was not possible to entertain that position without losing one's intellectual integrity. Thus, *à contre cœur*, he took a consequential position with respect to freedom, assigning instrumental value to it (e.g., Hayek 1960: 50, 85).

Jasay (p. 161) too wishes to eschew value judgments (such as "I prefer a free society over an unfree one"), and thus he tries to base his arguments for liberty solely on descriptive sentences.

An argument in favor of something that is recommended because it is judged to be valuable may be either (a) an argument whose premises have recourse to a final value, an intrinsic value, or (b) an argument based on an instrumental value—consequentialist, arguing that something is valuable because it is instrumental in bringing about consequences which are evaluated as valuable per se. A sentence that formulates a consequentialist argument is a descriptive sentence, i.e., a sentence the truth value of which is subject to empirical testing. It has only the form of a value judgment. Such an argument (type b) is provisional or, more accurately, incomplete. It presupposes a final value, because unless it does so, it can only lead to an infinite regress or a circle. To make it complete, to get a proper argument (a), the value judgment expressing the final value has to be made explicit. A final value by definition need not and cannot be justified. It is an arbitrary stopping point. Given subjective value theory, such a stopping point would be just that: arbitrary. Hence Jasay must require that his argument be valid in force of logic, "valid" in the sense of being logically sound, and hence he must require that it does not have recourse to a (genuine) value judgment. His attempt to produce an argument in favor of liberty is novel and extremely important. It rests on the assumption that feasible actions without a pending valid objection are admissible for logical reasons and thus must be treated as legitimate.

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In a nutshell, this is the argument. An individual x has a set of feasible acts, his option space. This set can be divided into two subsets: the set of acts *admissible* in society S (at time t) and the set of acts inadmissible in S. Let us assume that x claims that act A is admissible, i.e., that there are *no objections* to his performing A, and that x's claim is opposed by an individual y. Where is it rational (for lawmakers) to place the burden of proof—on the potential actor or on the objector (problem P)? The possible objections consist of laws and conventions in good working order. (Concrete cases have of course to be subsumed under the *type* cases described in the laws or implied in the conventions.) There are two clear-cut cases: (1) the list of objections considered relevant in S is explicit and thus finite; and (2) the list is "undenumerably" large (denumerably infinite), open, a fuzzy set. Type 2 cases are probably the only ones that matter in real-life situations. With respect to the list of objections (e.g., harming others), even in the context of law the expression "harm" allows interpretation, as does "breach of contract." Cases have to be subsumed under specific laws, and most laws turn out to be twistable to some extent. In addition to laws the list of inadmissible actions in practice includes conventions and customs, the breach of which leads to informal sanctions such as, for instance, ostracism.

In type 1 cases the problem P (where to place the burden of proof) is a matter of efficiency. The longer the list, the more costly it is for the actor to prove his case, i.e., to falsify the objector's claim. By contrast, unless he is acting frivolously, the potential objector has in mind a particular item on the list of objections. Hence for him the costs of verifying his claim are negligible.

In type 2 cases the problem P is a matter of logic and epistemology; the asymmetry between verifiability and falsifiability is decisive. (Verifiability and falsifiability are logical relations between sets of sentences.) The objector's claim is verifiable, whereas it is logically impossible to falsify the objector's claim. Hence it would be unreasonable (to say the least) to place the burden of proof on the actor.

In type 1 cases we assume that the denumerably finite list is consistent. Unless an inconsistency has been deduced we are entitled to do so—this is good enough for mundane purposes. With respect to type 2 cases it should be remembered that laws are twistable. Hence the consistency of the system may be doubted. When a glaring inconsistency has been shown, attempts should be made to improve the system.

In summary, Jasay's argument in favor of liberty (property and innocence) is incontrovertible. It does not have recourse to any (genuine) value judgment, i.e., to a sentence that is subjective and hence cannot have a truth value. It is *a matter of logic.* Does an argument in favor of liberty presuppose a preference for liberty? No. Constructing an argument is an exercise in logic. That it comments on and recommends liberty is merely its illocutionary force.

Jasay's argument entails the request to any rational being, in particular to legislators, not to request (in sincerity) what is logically impossible.

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This has nothing to do with value judgments: the logically impossible is literally "unthinkable," since thinking and logic are two sides of the same coin. "Ought implies can" is a descriptive statement.

The set of actions admissible in society (legal positivism) has an interesting subset: the set of objections valid in a Free Society, i.e., the list of actions inadmissible in a Free Society. Hence, for the friend of freedom, the theoretical test would be to match the objection at hand on the list of valid objections.

Everybody, even a seasoned political philosopher, can learn from Jasay's book, and the clarity and conciseness of his style make reading it a pleasurable experience.

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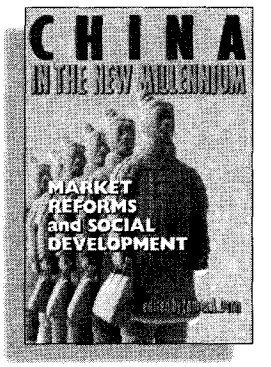

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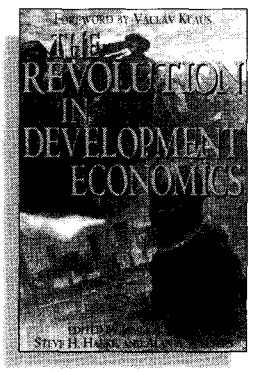

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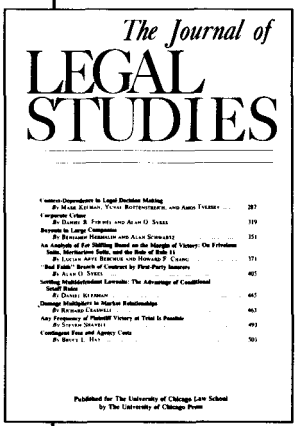

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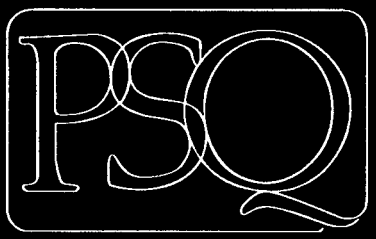

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ON GOOD GOVERNMENT

A good government in [the] classical liberal view is one that promotes "opulence" through a policy of promoting natural liberty by establishing laws of justice that guarantee free exchange and peaceful competition, the improvement of morality being left to nongovernmental institutions. It would be counterproductive for the state to legislate morality.

—Deepak Lal

Unintended Consequences (Cambridge, Mass.: MIT Press, 1998), 113.

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